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Proposed AICPA Audit and Accounting Guide : Airlines;Airlines; Exposure draft (American Institute of Certified Public Accountants), 2007, Sept. 12

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

American Institute of Certified Public Accountants. Airline Guide Task Force

EXPOSURE DRAFT

PROPOSED AUDIT AND ACCOUNTING GUIDE

AIRLINES

SEPTEMBER 12, 2007

Issued by the Accounting Standards Executive Committee
American Institute of Certified Public Accountants

Comments should be received by December 15, 2007, and sent by electronic mail to ymishkevich@aicpa.org or addressed to Yelena Mishkevich, Technical Manager, Accounting Standards,
AICPA, 1211 Avenue of the Americas, 19th Floor, New York, NY 10036

September 12, 2007

Accompanying this letter is an exposure draft of the proposed Audit and Accounting Guide *Airlines*.

Please note that Chapters 2, "General Auditing Considerations," and 10, "Special Reports and Example Reporting," of the proposed guide that contain auditing guidance are not included in this exposure draft.

The purpose of the exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties. The Accounting Standards Executive Committee (AcSEC) invites comments on all matters in the proposed guide and particularly on the issues outlined in the following paragraphs. In their comments, respondents should refer to specific paragraph numbers and include reasons for any suggestions or comments.

Revenue Breakage—Ticket Validity

Issue 1: The proposed guide defines *revenue breakage* as refundable and nonrefundable tickets that remain unused past departure date, have continuing validity (valid tickets), and are expected to ultimately expire unused, and valid travel vouchers that are not expected to be redeemed prior to their expiration date. The proposed guide indicates that invalid tickets are not revenue breakage and recommends that they be recognized as revenue at the point when they become invalid, which is usually the departure date.

a. Is the definition of revenue breakage appropriate, clear, and operational? If not, how should revenue breakage be defined?
b. Is guidance related to invalid tickets appropriate and operational? If not, why?
c. Is the point in time that a ticket has lost its value (generally the departure date) the appropriate time to recognize revenue for invalid tickets? If not, what would be the appropriate time for revenue recognition and why?

Please refer to the "Ticket Validity" and "Revenue Breakage" sections of Chapter 3 of the proposed guide (paragraphs 3.70–.71 and 3.72–.80, respectively).

Revenue Breakage—Timing of Revenue Recognition

Issue 2: The proposed guide describes two methods of recognizing revenue breakage for valid tickets: (1) at ticket expiration and (2) before expiration at the date when all services expected to be provided have been provided. The proposed guide states that recognizing revenue breakage for valid tickets at the date of expiration is the preferable accounting policy and that only if certain conditions are met may an airline elect to recognize breakage before expiration at the date when all services expected to be provided have been provided. If an airline meets those conditions and chooses to recognize breakage before expiration, revenue breakage may be recognized on the departure date.

a. Is that guidance appropriate and operational? If not, why?
b. Are there other appropriate methods for recognizing revenue breakage? If so, what are they?
c. Are the conditions that have to be met for recognizing revenue breakage before expiration appropriate? If not, what changes should be made to those conditions and why?
d. Is the departure date the appropriate point for recognizing revenue breakage under the second method? If not, what would be the appropriate time for revenue recognition under the second method and why?

Please refer to the "Passenger Revenue Recognition Model" section of Chapter 3 of the proposed guide (paragraphs 3.81–.88).

Ticket Change Fees—Timing of Recognition

Issue 3: The proposed guide describes two methods of accounting for ticket change fees: (1) as a separate and independent transaction from the original ticket sale and (2) as part of the original ticket sale. Under the first approach, change fees are viewed as a separate and independent transaction from the original ticket sale and revenue related to change fees is recognized when the fee is assessed, which might be either when the original ticket is cancelled or exchanged. Under the second approach, it is believed that there is only one deliverable (passenger transportation) and that change fees do not represent a separate revenue-generating event. As such, revenue related to change fees is recognized when the ultimate transportation service is provided.

a. Is that guidance appropriate and operational? If not, why?
b. Are there other appropriate methods for accounting for ticket change fees? If so, what are they?

Please refer to the "Change and Other Transaction Fees" section of Chapter 3 of the proposed guide (paragraphs 3.89–.94).

Frequent Flyer Programs—Incremental Cost and Deferred Revenue Methods of Accounting

Issue 4: The proposed guide describes two methods of accounting for Frequent Flyer Programs (FFPs): (1) incremental cost and (2) deferred revenue.

a. Are the descriptions of the two methods appropriate and sufficiently detailed to enable airlines to apply these methods? If not, how should these descriptions be revised?
b. Given the fact that the deferred revenue method is expected to become more prevalent in the future and considering the complexities involved in determining revenue under this method, should the proposed guide provide detailed guidance on how to calculate revenue under this method?

Please refer to the "Methods of Accounting for FFPs" section of Chapter 3 of the proposed guide (paragraphs 3.104–.111).

Accounting for Interline FFP Miles—Gross Versus Net

Issue 5: The proposed guide indicates that gross-basis accounting for interline FFP activity is the appropriate practice. Gross-basis accounting for interline FFP miles reflects the different accounting models applied to the individual components of the transaction (that is, sold miles are deferred while purchased miles from the other party should be a current expense).

Is that guidance appropriate? If not, why?

Please refer to the "Accounting for Interline FFP Miles" section of Chapter 3 of the proposed guide (paragraphs 3.115–.121).

Accounting for Interline FFP Miles—Effect on Valuation of FFP Liability

Issue 6: The proposed guide recommends that, when an airline that uses the incremental cost method for the valuation of FFPs enters into a contract with a new partner airline under which the airline's FFP members would be allowed to redeem their FFP miles on the partner airline, the airline accrue the additional liability based on the airline's best estimate of the portion of its FFP awards that will be settled on the new partner airline. The proposed guide provides that it would be inappropriate to not accrue a liability upon entering into a contract with a new partner due to a lack of historical experience with that particular airline. Under this guidance, an airline would be required to make an estimate upon entering into a contract with a new partner.

Is that guidance appropriate and operational? If not, why?

Please refer to the "Effect on Valuation of FFP Liability" section of Chapter 3 of the proposed guide (paragraph 3.121).

Manufacturer Purchase Incentives

Issue 7: Airlines frequently negotiate purchase and other incentives with flight equipment manufacturers whereby, as an inducement to purchase a particular manufacturer's aircraft, engine, parts or other flight equipment, the manufacturer will grant credits or other incentives to the airline. Sometimes manufacturers provide credits for purchase that increase based upon the number of aircraft ordered and that can apply to aircraft already delivered. Consistent with guidance in Emerging Issues Task Force (EITF) Issue No. 02-16, "Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor," the proposed guide provides that subsequent changes in the estimated manufacturer purchase incentives to be achieved are changes in estimate that should be recognized using a cumulative catch-up adjustment. That is, the airline would adjust the cumulative balance of the credit recognized to the revised cumulative estimate immediately and adjust depreciation, amortization, or rent expense accordingly in the current period.

Is that guidance appropriate and operational? If not, why?

Please refer to the "Manufacturer Incentives" section of Chapter 4 of the proposed guide (paragraphs 4.14–.21).

Performance Credits

Issue 8: With respect to manufacturer's credits issued to airlines for purposes other than the original acquisition of an aircraft or fleet, the proposed guide provides that the general premise is that credits issued to an airline as compensation for a short-term performance issue that is subsequently corrected are recognized as a reduction to expense, while credits issued for longer term performance issues are accounted for as a reduction in the cost basis of the aircraft because the airline has, in effect, paid less for a lower performing asset. For credits that are issued other than upon the initial acquisition of the aircraft and are accounted for as a reduction in the cost basis of the aircraft, an airline can either adjust depreciation, amortization, or rent expense solely on a prospective basis or record a cumulative catch-up adjustment to the appropriate expense caption computed as though the asset had been initially recorded at the reduced cost basis, based on the policy elected by the airline, which should be applied consistently.

a. Is that guidance appropriate and operational? If not, why?
b. Does the long-term versus short-term nature of the issue that gave rise to the credit constitute the appropriate factor to consider in determining whether to account for such credits as a reduction to expense or a reduction in the cost basis of the aircraft? If not, what would be the appropriate factor to consider and why?

Please refer to the "Manufacturer Incentives" section of Chapter 4 of the proposed guide (paragraphs 4.14–.21).

Liquidated Damages

Issue 9: Liquidated damages (frequently referred to as late delivery fees) are contractual payments made to an airline by an aircraft or equipment manufacturer due to the nondelivery of an aircraft or equipment by a stated delivery date. The proposed guide provides that liquidated damages should be accounted for in accordance with the guidance set forth in Technical Practice Aid Technical Questions and Answers section 2210.28, *Accounting for Certain Liquidated Damages* (AICPA, *Technical Practice Aids*), under which liquidated damages are typically recorded as a reduction of the cost of the asset and, therefore, reduce depreciation on a prospective basis, and EITF Issue No. 02-16. Amounts of liquidated damages in excess of the total cost of the asset would be recognized by the airline as income

Is that guidance appropriate? If not, why?

Please refer to the "Liquidated Damages" section of Chapter 4 of the proposed guide (paragraph 4.22).

Impairment of Long-Lived Assets

Issue 10: With respect to impairment testing performed under Financial Accounting Standards Board (FASB) Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the proposed guide provides that when a fleet comprises both owned aircraft (including aircraft under capital leases) and aircraft under operating leases, fleet level cash flows include the full ownership cost of the leased aircraft (that is, the full operating rent expense, which includes both capital cost and financing cost) while for owned aircraft and related fleet assets, only the capital cost should be assessed for recoverability. As a result, cash flows for the entire fleet will be determined, inclusive of the rental payments for leased aircraft, and compared to the carrying value of the assets in the asset group (that is, owned aircraft and related fleet assets), in the impairment assessment under FASB Statement No. 144.

Is the guidance for determining cash flows in situations involving a fleet of both owned and operating leased aircraft operational? If not, why?

Please refer to the "Cash Flows" section of Chapter 4 of the proposed guide (paragraphs 4.37–.40).

Lease Return Conditions

Issue 11: Aircraft lease agreements often contain provisions that require an airline to return aircraft airframes and engines to the lessor in a certain maintenance condition or pay an amount to the lessor based on the airframe and engine's actual return condition. The proposed guide provides that lease return costs should be accounted for in a manner similar to the accounting for contingent rent, that is, recognized over the remaining life of the lease in accordance with EITF Issue No. 98-9, "Accounting for Contingent Rent." The objective is to recognize the expense for lease return costs as the related aircraft hours accumulate, beginning when it is probable that such costs will be incurred and they can be estimated. The specific methods used to achieve this objective depend on the circumstances. The proposed guide also indicates that due to the nature of these agreements, incurrence of lease return costs becomes probable and the amount of those costs can typically be estimated near the end of the lease term (that is, after the aircraft has completed its last maintenance cycle prior to being returned).

Is that guidance appropriate? If not, what changes should be made to this guidance and why?

Please refer to the "Return Conditions" section of Chapter 4 of the proposed guide (paragraphs 4.52–.54).

Lease Return Conditions—Swaps

Issue 12: Often an airline will choose to satisfy lease return conditions by swapping engines as part of its overall engine maintenance program. The proposed guide provides that a lease-return liability would not need to be accrued if an airline has the intent and ability to satisfy lease return conditions through swapping engines and those swaps lack commercial substance, as described in FASB Statement No. 153, *Exchanges of*

Nonmonetary Assets. However, if it is concluded that the swaps have commercial substance, the proposed guide indicates that a lease return liability would need to be accrued. If the airline uses either the deferral or built-in overhaul method of accounting for planned major maintenance activities, unamortized maintenance would be written off when the engine is swapped.

Is that guidance appropriate? If not, why?

Please refer to the "Return Conditions" section of Chapter 4 of the proposed guide (paragraph 4.54).

Maintenance Deposits

Issue 13: Under the terms of most aircraft lease agreements, the airline, as lessee, is legally and contractually responsible for maintenance and repair of the leased aircraft throughout the lease term. However, to financially protect the lessor in the event the airline does not properly maintain the aircraft, some aircraft lease agreements include provisions that require the airline to make deposits with the lessor (frequently referred to as maintenance reserves or supplemental rent in the lease agreements). The proposed guide provides that if the payments relate to maintenance and do not meet certain risk transfer criteria (discussed in the "Outsourcing Maintenance" section of Chapter 4), these payments should be recorded as a deposit or prepaid expense, to the extent recoverable through future maintenance activities. When the underlying maintenance event occurs, it would be accounted for as maintenance expense or capitalized in accordance with the airline's maintenance accounting policy. Nonrefundable amounts that are not probable of being used to fund future maintenance activities would be recognized as expense.

Is that guidance appropriate? If not, why?

Please refer to the "Maintenance Deposits" section of Chapter 4 of the proposed guide (paragraphs 4.55–.56).

Amortization of Leasehold Improvements

Issue 14: Airlines execute leases with airport authorities for use of the gates, terminals, landing rights, and other operating needs. At some airports, lease terms are often month to month or on a shorter term basis and do not contain renewal provisions. Leasehold improvements should be amortized over the lesser of the useful life or the lease term, as defined in FASB Statement No. 13, *Accounting for Leases*. The proposed guide describes three criteria that, if met, make it appropriate for an airline to have an amortization period for certain leasehold improvement at airport facilities in excess of the stated contractual term (but no longer than the useful life of the leasehold improvement).

Is that guidance appropriate and operational? If not, why?

Please refer to the "Amortization of Leasehold Improvements" section of Chapter 4 of the proposed guide (paragraphs 4.67–.70).

Maintenance Expense

Issue 15: For parts sent to third-party FAA-approved maintenance repair stations for overhaul or repair or both, under the expense as incurred method, the estimated cost of maintenance should be accrued over the period of repair. In certain cases, however, airlines may not be able to account for those costs over the period of repair due to lack of necessary information on a timely basis or other practical considerations. As a result, airlines have developed simplified conventions that reasonably approximate the costs incurred over the repair period, which include accounting for the cost of the maintenance (1) when parts are shipped to the third-party vendor, (2) upon receipt of shop estimates from the third-party vendor, or (3) when the maintenance work is completed. The proposed guide provides that all of these options with third-party maintenance repair stations are considered acceptable as long as the airline chooses one approach and applies it consistently and the results do not materially differ from the results obtained by accruing the costs over the period of repair.

Is that guidance appropriate and operational? If not, why?

Please refer to the "Expense Recognition" section of Chapter 4 of the proposed guide (paragraph 4. 80).

Power-by-the-Hour Maintenance Arrangements—Risk Transfer

Issue 16: The proposed guide indicates that the issues relating to power-by-the-hour (PBTH) contracts and other similar arrangements with independent maintenance and repair providers include determining whether risk has been transferred to the service provider. The proposed guide sets forth risk transfer criteria that need to be considered to determine whether there is a transfer of risk. If the contract transfers risk, the proposed guide provides that the airline should recognize maintenance expense in accordance with the PBTH contract, as opposed to following its maintenance accounting policy. If a contract does not meet risk transfer criteria, the proposed guide indicates that the payments made under the contract should be recorded as a deposit or prepaid expense, to the extent recoverable through future maintenance activities. When the underlying maintenance event occurs, it would be accounted for as maintenance expense or capitalized in accordance with the airline's maintenance accounting policy.

a. Is that guidance appropriate? If not, why?
b. Are the risk transfer criteria appropriate and operational? If not, what should those criteria be?

Please refer to the "Outsourcing Maintenance" section of Chapter 4 of the proposed guide (paragraphs 4.81–.87).

Power-by-the-Hour Maintenance Arrangements—Expense Recognition

Issue 17: For PBTH contracts that transfer risk to the service provider, the proposed guide provides that there is a presumption that the expense should be recognized at a

level rate per hour during the minimum, noncancelable term of the PBTH agreement. That presumption could be overcome by evidence that the level of service effort varies over time, consistent with the variations in the payment pattern under the PBTH contract. For PBTH contracts with other than straight-line rates per hour, the presumption that expense should be recognized at a level rate per hour can be overcome by evidence that the level of service effort provided under the contract varies over time, and that the changes in the contractual rate per hour are consistent with the changes in the level of service effort to be provided under the PTBH contract. If such evidence exists, expense would be recognized based on the rates in the PBTH contract.

a. Is the presumption appropriate? If not, why?
b. Are the factors to consider in determining whether that presumption is overcome appropriate? If not, what factors should be considered and why?

Please refer to the "Outsourcing Maintenance" section of Chapter 4 of the proposed guide (paragraphs 4.88–.89).

Retroactive Pay Adjustments

Issue 18: Labor contracts in the airline industry are covered under collective bargaining agreements (CBAs) that are governed by the Railway Labor Act of 1926. Under the provisions of the Railway Labor Act, CBAs do not expire but rather become amendable as of a stated date. The contract negotiation process can be quite lengthy, and at times employees covered by a CBA have worked for a period of years beyond the amendable date under the existing CBA while the new CBA was being negotiated. Because of the significant delay, the new CBA may include provisions calling for retroactive wage payments to compensate employees for the period between the amendable date and the ratification date of the new contract. The proposed guide outlines a model based on FASB Statement No. 5, *Accounting for Contingencies,* for assessing whether it is probable that a liability for retroactive wages has been incurred and should be recorded. The model includes a description of events in the CBA negotiation process at which the probability that a liability has been incurred and the extent to which any liability is reasonably estimable should be evaluated.

Is the model provided in the proposed guide appropriate and operational? If not, why?

Please refer to the "Amendable Labor Contract" section of Chapter 5 of the proposed guide (paragraphs 5.02–.19).

Airport Operating Rights

Issue 19: The proposed guide defines *airport operating rights* as the value of a carrier's established operations at airports that have some or all of the following characteristics: significant barriers to entry exist at the airport, the airport is capacity constrained, or an airline has a substantial portion of the airport's capacity. The proposed guide indicates that airport operating rights would generally meet the separability criterion specified in FASB Statement No. 141, *Business Combinations*, because the airline's underlying

operations at the airport can be sold or leased in a separate transaction and therefore should be recognized as a freestanding intangible apart from goodwill. Separately identifiable slot intangible assets and certain gate lease valuation intangibles would also be recorded as separate intangibles and not as a component of airport operating rights.

a. Is that guidance appropriate and operational? If not, why?
b. Should airport operating rights be recognized as a freestanding intangible apart from goodwill and identifiable slot intangible assets and certain gate lease valuation intangibles? If not, why?
c. If airport operating rights are recognized as a freestanding intangible, what are the relevant considerations in determining the useful life of these assets?
d. Would it be appropriate to consider domestic airport operating rights an indefinite-lived intangible asset? Why or why not?

Please refer to the "Airport Operating Rights" and "Accounting Treatment" sections of Chapter 6 of the proposed guide (paragraphs 6.04–.06 and 6.11–.12, respectively).

International Route Authorities and Slots

Issue 20: The proposed guide describes two views on the impact of open skies agreements on the existence of individually recorded international intangible assets. One view is that individually recorded routes will no longer meet the definition of an asset because open skies agreements will eliminate restrictions on the number of airlines that can be granted a route. Accordingly, under this view, the value associated with such routes should be charged to expense and the related slots should be evaluated for impairment. The alternative view is that such separately recorded routes will continue to meet the definition of an asset in an open skies environment. Under this view, separately recorded routes and slots would need to be tested for impairment based on the guidance in FASB Statement No. 142, *Goodwill and Other Intangible Assets*, and EITF Issue No. 02-7, "Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets."

Is that guidance appropriate and operational? If not, why?

Please refer to the "Effect of Open Skies on the Existence of an Asset" section of Chapter 6 of the proposed guide (paragraphs 6.20–.22).

Issue 21: The proposed guide describes two views on whether the possibility of open skies should affect the indefinite-lived status of separately recorded routes, slots, and combined assets. One view is that airlines should not anticipate ratification of open skies in the future and would not consider it as a factor when evaluating the remaining useful life of these assets until open skies access is granted in the country to which the international route authority asset pertains**.** The second view is that airlines should take into account all relevant factors and consider the likelihood of this regulatory change and its effect on the indefinite-lived status of separately recorded routes, slots, and combined assets before the actual ratification.

Is that guidance appropriate and operational? If not, why?

Please refer to the "Useful Life" section of Chapter 6 of the proposed guide (paragraphs 6.23–.30).

Issue 22: Example 6 in Appendix A to FASB Statement No. 142 indicates that international route authorities are indefinite-lived intangible assets. The proposed guide indicates that once an open skies agreement is effective, even though the cash flows associated with international route authorities may continue indefinitely, they will do so at a diminished level, thus potentially resulting in an impairment and a reassessment of the useful life of these assets. While a particular situation should be evaluated based on its facts and circumstances, the proposed guide indicates that, after the ratification of open skies, international intangible assets may be more appropriately considered to be finite-lived assets.

a. Is that guidance appropriate? If not, why?
b. Are there circumstances in which an international route authority between countries with an open skies treaty should be considered an indefinite-lived intangible asset? If so, what are they?

Please refer to the "Useful Life" section of Chapter 6 of the proposed guide (paragraphs 6.23–.30).

Revenue Recognition for Planned Major Maintenance Activities

Issue 23: Under most capacity purchase agreements, the major airline reimburses the regional airline for planned major maintenance, and these payments may not coincide with the performance of the maintenance services. The proposed guide provides that there are two acceptable approaches to account for revenue related to planned major maintenance received under capacity purchase agreements that contain a lease under EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease": (1) regional airlines may choose to consider payments related to planned major maintenance as reimbursement of an executory cost as defined in FASB Statement No. 13, *Accounting for Leases*, or (2) account for maintenance-related revenue following FASB Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*. The proposed guide provides guidance about how to apply both of these methods.

Is that guidance appropriate and operational? If not, why?

Please refer to the "Revenue Recognition for Planned Major Maintenance Activities" section of Chapter 9 of the proposed guide (paragraphs 9.43–.50).

Up-Front Contract Payments

Issue 24: When a regional airline enters into a new capacity purchase agreement with a major airline or, less frequently, when the contract is modified, for example, to include additional aircraft or make a significant modification to the service offering or model, the

regional airline performs certain activities at the request of the major carrier to support the new contract or activities. These activities include, for example, painting the exterior and reconfiguring the interior of the aircraft to conform to the décor of the major airline and training customer service personnel in the use of the major airline's reservation system. The cost of certain of these activities is often reimbursed by the major carrier pursuant to the capacity purchase agreement. The proposed guide indicates that the major airline pays the up-front fees for services provided by the regional airline solely to facilitate the provision of flights under the capacity purchase agreement and that, as such, the provisions of Staff Accounting Bulletin No. 104, *Revenue Recognition*, should be applied, which, in most cases, would result in revenue recognition over the term of the capacity purchase agreement for such upfront payments.

The proposed guide indicates that the nature of direct costs associated with providing these services should be evaluated to determine whether they should be capitalized or expensed. For example, costs incurred to paint the exterior and reconfigure the interior of the aircraft to conform to the décor of the major airline might be either expensed or capitalized depending on the airline's asset capitalization policy for its aircraft. However, in situations in which the regional airline concludes that the revenue should be deferred, other types of costs (for example, training and aircraft reconfiguration costs that are not capitalizable under the airline's asset capitalization policy) may qualify for capitalization as an asset, provided they meet the requirements of EITF Issue No. 99-5, "Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements."

Is that guidance appropriate? If not, why?

Please refer to the "Up-Front Contract Payments" section of Chapter 9 of the proposed guide (paragraphs 9.51–.58).

Incremental GAAP

Issue 25: As explained in the Notice to Readers of the proposed guide, the previous edition of this guide as of May 1, 2003, has established accounting principles that are not promulgated elsewhere (referred to as *incremental GAAP*). The 2003 edition of this guide is not superseded because it remains a source of level *b* GAAP and because the proposed guide brings forward incremental GAAP from the 2003 edition. Appendix A of the proposed guide provides analysis of how and where incremental GAAP guidance from the 2003 edition appears in the revised guide.

In addition to the sections identified in Appendix A, are there other sections of the 2003 edition that contain incremental GAAP? If so, what are they?

Please refer to Appendix A of the proposed guide.

Standing of the Proposed Guide in GAAP Hierarchy

Issue 26: As explained in the Notice to Readers of the proposed guide, the 2003 edition of this guide was cleared by the FASB and, therefore, was deemed to be within level *b* of the hierarchy of sources of GAAP. The proposed guide, when finalized, would be within

level *d* of the hierarchy of sources of GAAP. Because of that, no transition guidance is provided in the proposed guide.

Is the explanation in the Notice to Readers clear? If not, how should the explanation be revised?

Please refer to Notice to Readers of the proposed guide.

Comments on the exposure draft should be sent by electronic mail to ymishkevich@aicpa.org or addressed to Yelena Mishkevich, Technical Manager, Accounting Standards, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by December 15, 2007.

Written comments on the exposure draft will be posted to the AICPA Web site at www.aicpa.org for one year.

Sincerely,

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NOTICE TO READERS

This AICPA Audit and Accounting Guide has been developed by the AICPA Airline Guide Task Force to assist management of reporting entities in their preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) and to assist auditors in auditing and reporting on such financial statements.

Accounting Guidance

The financial accounting and reporting guidance contained in this guide has been approved by the affirmative vote of at least two thirds of the members of the Accounting Standards Executive Committee (AcSEC), which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting.

The previous edition of this guide as of May 1, 2003, was cleared by the Financial Accounting Standards Board (FASB) and, therefore, was deemed to be within level *b* of the hierarchy of sources of GAAP that is currently described in Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles. Prior to issuing this exposure draft edition of the guide, however, the AICPA and FASB agreed that FASB would no longer clear new editions of guides or new guides and that new editions or new guides would be within level *d* of the hierarchy of sources of GAAP. Accordingly, this edition of the guide is within level *d* of the GAAP hierarchy.

The previous edition of this guide as of May 1, 2003, may have established accounting principles that are not promulgated elsewhere. The 2003 edition of this guide is not superseded because it remains a source of level *b* GAAP. However, the reader need not refer to the 2003 edition because this edition of the guide conveniently brings forward accounting principles established by the 2003 edition.

This guide does the following:

- Identifies certain requirements set forth in pronouncements in levels *a*, *b*, and *c* of the hierarchy of sources of GAAP. In these instances, entities are required to apply those requirements based on their standing in levels *a*, *b*, or *c* of the hierarchy rather than because of their inclusion in this guide.

- Describes AcSEC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that AcSEC expresses a preference for the prevalent or sole industry practice, or it may indicate that AcSEC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, AcSEC may express no view on the matter.

- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing AcSEC's views on them.

- Provides guidance that has been supported by AcSEC on the accounting, reporting, or disclosure treatment of transactions or events that is not set forth in pronouncements in levels *a*, *b*, and *c* of the hierarchy of sources of GAAP.

Proposed AICPA Audit and Accounting Guide

Airlines

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Chapter 1

The Airline Industry

Background

1.01 The United States first began promoting the airline industry through the adoption of the Air Mail Acts of 1925 and 1926, which transferred the carriage of mail from the U.S. Post Office to private carriers. Previously, although there had been interest in the development of military aircraft, private carriers had been unable to generate profits in substantially cargo-related efforts. After passage of the Air Mail Acts, growing demand created by a small but competitive airline industry stimulated the production of aircraft specifically designed for passenger and cargo service.

1.02 The airline industry continued to grow despite the depression of the 1930s. Technological developments and a new network of lighted airports with reliable communication equipment created the environment for industrial growth. In 1938, the Civil Aeronautics Act provided government regulation of market entry and exit, air safety, and rates.

1.03 World War II stymied airline industry growth because military demands limited the amount of equipment and service that was available for civilian passenger service. However, military developments in aviation produced many improvements that would result in more efficient and affordable service.

1.04 Jet service was introduced in the late 1950s. The Federal Aviation Act was passed in 1958, creating the Federal Aviation Administration (FAA), which developed the air traffic control system. Subsequent technological advances and improvements resulted in

dramatic increases in property and equipment investment by U.S. scheduled airlines throughout the last half of the century.

1.05 The 1970s saw dramatic increases in costs, particularly increases in fuel prices. In 1978, the Airline Deregulation Act (ADA) amended the Civil Aeronautics Act of 1938 to promote competition in the airline industry while maintaining high standards for safety. After deregulation, many changes occurred in the industry, including a proliferation of smaller regional airlines and low-cost carriers and an increase in mergers and airline bankruptcy filings. This is demonstrated by the fact that 128 airlines filed for bankruptcy in the 18 years following deregulation.

1.06 One of the arguments against deregulation was that some smaller communities would be denied commercial air services. In response, the Department of Transportation (DOT) implemented the essential air services program. Participating airlines enter into a two-year contract with the DOT, which subsidizes flights and imposes requirements on the number of seats and flights that must be offered and their destinations.

1.07 As previously discussed, many low-cost carriers were founded due to deregulation during the 1970s and continued to expand rapidly through the early 2000s. Low-cost carriers are classified as such due to some of the following cost structures that are different from those of traditional (sometimes also referred to as *legacy*) airlines: simplified fleets, which reduce maintenance costs; a more flexible labor agreement, which results in a more productive workforce and greater flexibility in establishing work rules; and limited pension and postretirement benefits, which have become a significant cost for traditional carriers. Although the low-cost carriers' markets were not as extensive as those of traditional airlines, extreme pricing pressure was placed on important routes. Additionally, with the expansion of the Internet in the 1990s, passengers had greater ability to find the lowest fare in booking travel.

1.08 In the 1990s, airlines experienced a strong period of growth, and air travel demand continued to increase. As a result, airlines responded with increased capacity, lower fares, and expansion into more markets.

1.09 Beginning in late 1999 and early 2000, the economy suffered, which resulted in a significant decrease in demand for air travel. The depressed demand for business travel was compounded by the terrorist attacks on September 11, 2001, which had a dramatic effect on the airline industry. Immediately following these tragic events, U.S. airlines experienced numerous difficulties, including a significant drop in demand for air travel, reduced traffic and yields, increased insurance and security costs, and liquidity concerns. In response, the federal government provided assistance to airlines, making federal grants and conditional loan guarantees available. The government also provided relief from increased war risk insurance premiums and limited liability for terrorist attacks. Heightened security concerns resulted in the formation of a new governmental agency, the Transportation Security Administration (TSA), which is responsible for all aviation security. New TSA requirements were the primary factors that contributed to increased security costs covering passenger screening and additional security requirements for aircraft. The airline industry responded to these economic downturns with significant cost restructurings, including labor concessions, reductions in force, reductions in capacity via aircraft groundings and scheduling modifications, and bankruptcy filings.

1.10 The years following the events of September 11, 2001, continued to be financially difficult, specifically for the traditional carriers. Compared with historical periods, yields continued to be depressed due to the strong competition from low-cost carriers and reduced demand for air travel. Therefore, the traditional carriers continued various cost-cutting initiatives, which, in addition to reductions in force and labor concessions, included efforts to reduce or eliminate pension and postretirement benefits, which constitute a significant component of certain airlines' cost structure. Many of the traditional carriers continued to be highly leveraged, which resulted in additional carriers filing for bankruptcy protection. During this period, the industry also experienced some of the highest prices of fuel, which led to further financial deterioration of many carriers.

The high cost of fuel affected both traditional and low-cost carriers; however, due to poor credit ratings, many of the traditional carriers were unable to hedge fuel, which resulted in continued significant operating losses.

1.11 The accounting considerations associated with various airline industry practices summarized in this chapter are discussed further in Chapters 3–9.

History of Regulation

1.12 The airline industry has been regulated in three major areas: market entry and exit, rates, and air safety. All three areas of regulatory responsibility came into existence with the Civil Aeronautics Act of 1938. The act created the Civil Aeronautics Board (CAB), whose primary duty, until amended by the ADA, was to promote and regulate the airline industry. The board's mandate was twofold: to maintain the highest priority for safety and to encourage competition in the airline industry. The key elements of deregulation were freedom of market entry and exit and freedom of pricing. A third element is protection of service to small communities.

1.13 The ADA terminated the CAB's authority over rates and route access on January 1, 1983. In addition to liberalizing the general provisions for awarding certificates to new airlines, the ADA established new provisions for automatic market entry and issuance of experimental certificates on a temporary basis. Other provisions eased restrictions on suspension and reduction of service and expedited market entry and exit. As a result, the ADA has enabled many new entrants to gain access to domestic markets and has allowed the legacy carriers to expand and otherwise alter their service patterns. Airlines are now classified as certificated scheduled (route) airlines, certificated nonscheduled (charter) airlines, air cargo airlines, and intrastate airlines. Within the route airline classification, airlines are now identified as major, national, regional, and air-taxi operators.

U.S. Government Regulation[1]

Department of Transportation

1.14 The ADA transferred responsibility for overseeing airline operations to the DOT when it was passed in 1978. The DOT is the primary agency that oversees the national transportation policy. This includes negotiation of international transportation agreements, preparing transportation legislation, and ensuring the general fitness of U.S. airlines. The DOT is also responsible for approving merger proposals and sales of international airline routes. The Secretary of Transportation, who is nominated by the President of the United States, heads the DOT.

1.15 The DOT has authority to issue certificates of public convenience and necessity required for airlines to provide domestic air transportation. An airline that the DOT deems fit to operate is given unrestricted authority to operate domestic air transportation, including the carriage of passengers and cargo. Except for constraints imposed by Essential Air Service regulations, which are applicable to certain small communities, airlines may initiate and terminate service to a city without restriction.

1.16 The DOT has jurisdiction over certain economic and consumer protection matters such as unfair or deceptive practices or methods of competition, advertising, denied boarding compensation, baggage liability, and disabled passenger transportation. The DOT also has authority to review certain joint venture agreements between major airlines.

1.17 Authority to operate international routes and international code-sharing arrangements is regulated by the DOT and by the foreign governments involved. International route awards are also subject to the approval of the President of the United States for conformance with national defense and foreign policy objectives.

1 This guide does not describe government regulations in countries other than the United States.

1.18 Under federal law and DOT regulations, airlines must be controlled by U.S. citizens. The president of the airline and two-thirds of the board of directors must be U.S. citizens, and not more than 25 percent of outstanding common stock may be voted by non-U.S. citizens. Foreign ownership must be less than 50 percent.

Federal Aviation Administration

1.19 The FAA is a component of the DOT with primary responsibility for the safety of the U.S. air system. The FAA has primary responsibility for matters relating to airline flight operations, including airline operating certificates, control of navigable air space, flight personnel, aircraft certification and maintenance, and other matters affecting air safety. The agency is also responsible for research and development as it pertains to improving our National Airspace System.

1.20 FAA requirements cover security measures, issuance of airworthiness directives, collision avoidance systems, airborne wind-shear avoidance systems, noise abatement and other environmental concerns, commuter aircraft safety, and increased inspections and maintenance procedures to be conducted on older aircraft. The FAA monitors compliance with regulations and may assess fines for noncompliance.

Department of Homeland Security

1.21 Established on March 1, 2003, the Department of Homeland Security (DHS) is responsible for protecting the movement of international trade across U.S. borders, for maximizing the security of the international supply chain, and for engaging foreign governments and trading partners in programs designed to identify and eliminate security threats before they arrive at U.S. ports and borders.

Transportation Security Administration

1.22 In November 2001, the Aviation and Transportation Security Act (ATSA) was enacted. The ATSA created a new government agency, the TSA, which later became a part of the DHS, which is responsible for aviation security. The ATSA mandates that the TSA provide for the screening of all passengers and property, including U.S. mail, cargo,

carry-on and checked baggage, and other articles that will be carried aboard a passenger aircraft. The ATSA also provides for increased security in cockpits of aircraft and requires federal air marshals to be present on certain flights. The operations of the TSA are funded primarily through a passenger security fee, which is a flat fee charged per ticket that the airlines collect and remit to the TSA. Since 2002, the TSA has also imposed an aviation security infrastructure fee on all airlines to assist in the cost of providing aviation security.

Environmental Protection Agency

1.23 The Environmental Protection Agency (EPA) regulates certain aspects of operations, including airline operations, in the United States. Among other things, airlines are subject to the following federal environmental protection laws:

- *Clean Air Act.* The Clean Air Act is the federal law passed in 1970, which, as amended, forms the basis for the national air pollution control effort. Basic elements of the act include national ambient air quality standards for major air pollutants, hazardous air pollutants standards, state attainment plans, motor vehicle emissions standards, stationary source emissions standards and permits, acid rain control measures, stratospheric ozone protection, and enforcement provisions. Aircraft engine emissions can affect local air quality as well as create global atmospheric concerns.

- *Clean Water Act.* Growing public awareness and concern for controlling water pollution led to enactment of the Federal Water Pollution Control Act Amendments of 1972. As amended in 1977, this law became commonly known as the Clean Water Act. The act established the basic structure for regulating discharges of pollutants into the waters of the United States. It gave the EPA the authority to implement pollution control programs such as setting wastewater standards for industry. The Clean Water Act also continued requirements to set water quality standards for all contaminants in surface waters. Jet fuel spills, leaks from underground storage tanks or pipelines used to transport and store jet fuel,

and solvents used by aircraft maintenance facilities frequently contaminate water sources.

- *Airport Noise and Capacity Act of 1990.* The Airport Noise and Capacity Act of 1990 recognizes the right of airport operators with special noise problems to implement local noise abatement procedures as long as those procedures do not interfere unreasonably with the interstate and foreign commerce of the national air transportation system. As a result of litigation and pressure from airport area residents, airport operators have taken local actions over the years to reduce aircraft noise. These actions include restrictions on night operations, restrictions on frequency of aircraft operations, and various operational procedures for noise abatement.

Occupational Safety and Health Administration

1.24 The Occupational Safety and Health Administration (OSHA) was created in 1971 with a mission to ensure a safe and healthful workplace in the United States. OSHA sets and enforces standards; provides training, outreach, and education; establishes partnerships; and encourages continuous improvement in workplace safety and health. It intends to act as a leader in joining other health and safety communities in prioritizing health and safety issues and setting a clear agenda for safety consciousness.

Other

1.25 The U.S. Department of Justice has jurisdiction over airline competition matters. The U.S. Postal Service has authority over certain aspects of the transportation of mail. The Railway Labor Act generally governs labor relations in the airline industry.

International Air Transportation

1.26 Airline operations between countries continue to be governed by specific bilateral agreements between the countries. The access of U.S. airlines to routes between the

United States and other countries requires the approval of the respective countries for landing rights at specified airports and frequency of flights.

The International Air Transport Association

1.27 The International Air Transport Association (IATA), a voluntary organization of international airlines, was established in 1946 to negotiate international airfares, cargo rates, conditions of service, and ancillary matters. The Federal Aviation Act required U.S. airlines participating in such an organization to obtain approval from the CAB. In 1946, the CAB granted U.S. airlines immunity from antitrust laws, permitting them to participate in IATA conferences for the purpose of establishing fares and rates. Agreements reached by the airlines at those meetings are subject to the approval of the respective governments.

1.28 In anticipation of deregulation in the United States, IATA established two types of airline participation. One deals with facilitation matters and is mandatory for all members; the other sets fares and rates for air transportation. Participation in the latter is optional, but a member choosing to participate in fare and rate conferences must do so for all areas served.

Open Skies or Route Authorities

1.29 The availability of international routes to U.S. airlines is regulated by treaties and related agreements between the United States and foreign governments. The United States typically follows the practice of encouraging foreign governments to accept multiple airline designation on foreign routes, although certain countries have sought to limit the number of airlines allowed to fly these routes to protect their national "flag" airlines. Certain foreign governments impose limitations on the ability of airlines to serve a particular city or airport within their country from the United States. For a U.S. airline to fly to any such international destination, it must first obtain approval from both the United States and the foreign country where the destination is located, which is referred to as a *foreign route authority*. Studies have shown that international routes for which there is a limit to the number of airlines or frequency of flights (such as Heathrow airport

in London) have more value than those without restrictions. Route authorities to some international destinations can be sold between airlines, and their value can vary because of limits on accessibility. To the extent foreign countries adopt "open skies" policies (meaning all airlines have access to the destination), liberalizing or eliminating restrictions on international routes would increase competition and potentially decrease the value of a route, subject to airport availability. Please refer to Chapter 6 for further discussion of international route authorities and related accounting considerations.

Air Transport Association of America

1.30 Founded in 1936, the Air Transport Association of America (ATA) is a trade and service organization representing member U.S. scheduled airlines. The joint interests of the airlines as an industry are expressed through a system of councils and related committees on which airline and ATA representatives work together.

1.31 Because travel agent sales, including Internet travel agencies, constitute a significant portion of the airline business, the ATA designed the Area Settlement Plan (ASP), which is operated by the Airlines Reporting Corporation. The plan enables each travel agent to submit one sales report to an area processing center that then distributes the agent's sales and receivables transactions to the respective airlines. Because the dollar volumes involved and competitive needs for sales information are substantial, the ASP program requires continuous monitoring and updating. The ATA provides this service to the airlines and travel agents. A number of low-cost carriers have discontinued using travel agencies in lieu of direct Internet sales, which contributes another factor to their lower cost structure.

1.32 Other plans, called bank settlement plans (BSPs), have been established and are now available in most countries around the world except for certain lesser-developed countries. The BSPs, although not identical to the ASP, contain many of the same features.

Regional Airline Association

1.33 The Regional Airline Association, formerly the Commuter Airline Association, is the national association of member airlines engaged in scheduled air transportation of passengers and cargo in local, feeder, and short-haul markets throughout the United States and its territories. In addition, the association's finance and accounting committee has developed a uniform system of accounts for regional airline use.

Characteristics of the Industry

Operating Environment

Economy

1.34 Airline profitability is highly sensitive to economic factors, including the ability to attract and retain business and leisure passengers; the effects of any hostilities, acts of war, or terrorist attacks; disease and epidemics; the cost and availability of aircraft insurance; volatility in the cost of aviation fuel; competitive pressures on pricing; and government regulation.

Competition

1.35 The airline industry is highly competitive. Airline profits are sensitive to adverse changes in fuel costs, average fare levels, and passenger demand. Since deregulation, passenger demand and fare levels have been influenced by, among other things, the general state of the economy, international events, industry capacity, and pricing actions taken by other airlines. The principal competitive factors in the airline industry are fare pricing, customer service, routes served, flight schedules, types of aircraft, safety record and reputation, code-sharing relationships, in-flight entertainment systems, and frequent flyer programs.

1.36 International marketing alliances formed by domestic and foreign airlines have increased competition significantly in international markets. Through marketing and code-sharing arrangements with U.S. airlines, foreign airlines have obtained access to

domestic U.S. routes. Similarly, U.S. airlines have increased their ability to sell international transportation such as transatlantic services to and beyond European cities.

Seasonality

1.37 In general, demand for air travel in the United States is higher in the June and September quarters because there is more vacation travel during those periods than during the remainder of the year. Demand for air travel is also affected by factors such as economic conditions, war or the threat of war, fare levels, and weather conditions. In addition, demand for air travel at particular airlines may be affected from time to time by, among other things, actual or threatened disruptions to operations due to labor issues.

Airline Classifications

1.38 The DOT classifies U.S. airlines primarily by operating revenue and aircraft size using the following definitions, which are used by the DOT for statistical reporting purposes:

- *Major airline*. A major airline is one that generates over $1 billion in annual operating revenue. Major airlines often have international operations. Major airlines are also categorized as traditional carriers or low-cost carriers. Many of the low-cost carriers that have grown from the 1970s to the 2000s serve primarily domestic markets.
- *National airline*. A national airline is one that generates between $100 million and $1 billion in annual operating revenue. National airlines operate primarily in the United States.
- *Regional airline*. A regional airline is one that generates less than $100 million in annual operating revenue. Regional airlines are characterized by having a predominantly regional aircraft fleet (fewer than 100 seats) and typically fly within clear geographic boundaries, providing feed and supplementary service to major airlines. The regional airline typically provides such supplementary service to one or two airlines under a capacity purchase agreement.

- *Air cargo carrier*. Air cargo carriers specialize in the transportation of mail, parcels, and freight.

1.39 The DOT specifies these definitions. Industry participants, however, frequently refer to the airlines based on the following criteria (the operating models referred to in this section are defined in paragraphs 1.40-1.42 of this chapter):

- *Network* or *major carrier* generally refers to legacy carriers that existed before airline deregulation and have traditionally operated under a hub-and-spoke system.
- *Low-cost carrier* generally refers to carriers established after deregulation that focus on point-to-point operations and generally have only one class of service.
- *Regional carrier* refers to carriers that generally provide either contract flying or connecting service for a network carrier.

Operating models

1.40 Airlines typically operate using the hub-and-spoke model or the point-to-point model, but some airlines use a combination of both models.

1.41 The hub-and-spoke system concentrates most of an airline's operations in a limited number of hub cities, serving most other destinations in the system by providing one-stop or connecting service through the hub between destinations on the spokes. Such an arrangement permits travelers to fly from a point of origin to more destinations without switching airlines. Hub airports permit airlines to transport passengers between large numbers of destinations with substantially more frequent service than if each route were served directly.

1.42 The point-to-point model spreads the airline’s resources over a number of cities and focuses on providing high frequency, point-to-point service (flying from one city to another without stopping in a connecting city). This typically results in higher aircraft utilization and allows fixed costs to be spread over more hours of flying.

Other

1.43 Many airlines offer charter service to the public. In addition, many airlines participate in the Civil Reserve Air Fleet (CRAF) program. In time of war or during an unlimited national emergency or civil defense emergency, airlines can be required to provide airlift services to the Air Mobility Command under the CRAF program. Both mandatory and voluntary missions are a part of this program.

1.44 Many major airlines offer both domestic and international cargo, freight, and mail shipping services.

Fuel

1.45 Fuel costs constitute a significant portion of operating expenses for all airlines. The effect of fuel price changes on an individual airline depends upon various factors, including the airline's hedging strategy.

1.46 In the event there is an outbreak of hostilities or other conflicts in oil-producing areas of the world, there could be reductions in the production or importation of crude oil or significant increases in the cost of fuel. If there were major reductions in the availability of jet fuel or significant increases in its cost, the entire airline industry would be adversely affected.

1.47 Since the mid-2000s, the fuel prices have been historically high and extremely volatile. Given the significance of fuel costs to airline operations and the volatility of fuel prices, airlines typically engage in hedging programs to mitigate price risk. However, after September 11, 2001, the low-cost carriers typically have been the primary carriers able to initiate substantial hedging programs due to the significant decline in the creditworthiness of the traditional carriers. Please refer to Chapter 6 for further discussion of fuel hedging.

Taxes and Fees

1.48 The U.S. airline industry is one of the most heavily taxed of all industries. Taxes and fees represent approximately 25 percent of the price of an average airline ticket, including customs and excise tax, foreign departure taxes, fuel taxes, security fees, and airport passenger facility charges. These taxes and fees have increased significantly in the past decade, most recently with the introduction of a security fee imposed on each passenger flight segment, which is being collected by the airlines and submitted to the government to pay for enhanced security measures after September 11, 2001. Security fees have been assessed by the government based on the airline's historical passenger screening costs but may also be assessed based on the airline's market share or on some other basis as determined by the government. A myriad of international taxes exist that are as varied as the countries assessing them, such as stamp taxes, departure taxes, and value-added taxes. Many of these taxes are collected at the time of sale but remitted at departure based on the number of passengers boarded. Please refer to Chapter 3 for further discussion of taxes and fees and related accounting considerations.

Insurance

1.49 Airlines carry insurance to cover public liability, passenger liability, property damage, war risk, and all-risk damage to their aircraft. As a result of the events on September 11, 2001, aviation insurers have significantly reduced the amount of insurance coverage available to commercial airlines for liability to persons other than employees or passengers for claims resulting from acts of terrorism, war, or similar events (war-risk coverage). At the same time, they significantly increased the premiums for such coverage as well as for aviation insurance in general. Accordingly, such coverage is periodically supplemented by the U.S. government. Please refer to the "Insurance" section in this chapter for an in-depth discussion of airline insurance programs.

Maintenance

1.50 Maintenance costs represent a significant portion of the combined operating expenses of airlines. To make maintenance more efficient, some airlines have entered into pooling agreements. Pools of materials and parts are maintained separately by the

individual airlines and made available to other airlines as required. Benefits result from reduced inventory requirements.

1.51 In recent years, in an effort to reduce maintenance costs, many airlines have resorted to having maintenance performed by independent maintenance providers. As a result, a number of new developments have occurred in the maintenance and engineering arena. Those developments include (*a*) power-by-the-hour contracts with independent maintenance and repair entities, wherein the airline pays the service provider a fixed amount per flight hour in exchange for maintenance and repairs, or other agreements with payments based on actual time and materials costs and (*b*) maintenance joint ventures between an airline and an independent maintenance and repair entity to perform maintenance and repairs primarily on the airline's airframes and engines and perhaps those of other airlines as well. In addition, many lease agreements now include various provisions for maintenance. Please refer to maintenance accounting considerations discussed in Chapter 4.

Unionization

1.52 Labor relations are a significant factor in the airline industry. The existence of several unions per airline means that contract negotiations may be in progress constantly. Airline industry employee unions are governed by the Railway Labor Act of 1926, which permits Congress to intervene in the negotiation or settlement of strikes that create a national emergency by threatening to cripple the transportation industry. The Railway Labor Act and the associated accounting considerations are discussed further in Chapter 5.

1.53 Labor unionization makes restructuring efforts by traditional carriers difficult given the work rules established in contracts, the seniority pay systems, and the substantial retirement benefits.

Marketing Strategy

Distribution channels

1.54 Most airlines sell tickets through Global Distribution Systems (GDSs), including Amadeus, Galileo, SABRE, SystemOne, and WorldSpan. These systems provide flight schedules and pricing information and allow travel agents to process a flight reservation electronically without contacting an airline's reservations facility. Travel agents' reliance on GDSs has, from time to time, significantly increased the cost of making reservations, which is borne primarily by airlines that subscribe to the GDS. Airlines historically also paid commissions to travel agencies, but, with the growth of Internet travel Web sites, most domestic commissions have been eliminated. Many travel agencies now assess a separate fee on the customers.

1.55 Most airlines also have a direct reservation option, either through call centers or their Web site. To attract customers to their Web sites, the airlines provide discounts to customers who book reservations on their Web sites.

1.56 There has also been a significant increase in Internet travel Web sites, including Priceline©, Orbitz©, Expedia©, and Hotwire©. The advent of these Web sites has not only resulted in significant distribution cost savings for airlines but has also had a negative effect on airline revenue. Having access to "perfect pricing information," air travel consumers have become more efficient at finding lower fare alternatives than in the past. The increased price consciousness of travelers, as well as the growth in distribution channels, has further motivated airlines to price aggressively to gain fare advantages through certain channels. Airlines' distribution channels are further discussed in the "Sales Reporting" section of Chapter 3.

Airline alliances

1.57 Several types of arrangements allow two or more airlines to coordinate services to their customers. A code-sharing arrangement enables a ticketing airline to issue tickets on the operating airline and to use that operating airline's two-letter code when doing so in computer reservation systems. Such alliances also usually tie in each airline's marketing and frequent flyer programs and provide for schedule coordination for convenient

connections between airlines. Please refer to Chapter 3 for further discussion of airline alliances and related accounting considerations.

1.58 In addition, major airlines have agreements with regional airlines that permit the major airlines to expand their overall network and maximize their existing route structure by providing a greater number of travel options to customers. Under traditional revenue sharing agreements, regional airlines generally received a prorated portion of the passenger ticket revenue plus an incentive to connect the passengers to the longer segment, flown by the major airline. However, with the advent of regional jets, a number of the arrangements with the regional airlines were changed to capacity purchase agreements. Under these arrangements, the major airline purchases the entire capacity of the aircraft at a specified cost. The major airline generally pays the regional airline a rate based on certain flying statistics, such as block hour, with additional incentives and penalties based on such factors as completion of flights, on-time performance, and satisfactory baggage handling. The major airline is responsible for scheduling the regional airline's flights, determining pricing, and selling the tickets. The major airline retains the revenue pricing risk and bears the risk of changes in the price of fuel, which, in turn, shelters the regional to some degree from many of the elements that cause volatility in airline earnings. Major airlines use capacity purchase agreements because these agreements allow them to expand their operations at lower fixed costs, thereby enabling them to serve strategic routes that otherwise might be uneconomical. Major airline alliances with regional carriers are further discussed in Chapter 3 (from the major airline's perspective) and Chapter 9 (from the regional airline's perspective).

Frequent flyer programs

1.59 Frequent flyer programs, which began in the 1980s to encourage travel and promote customer loyalty to a respective airline, have resulted in significant revenue from other entities that pay for access to airline customer lists and trade names and who provide frequent flyer miles to their customers in exchange for various purchases. Those entities include cooperative partners, which are primarily credit card companies, hotels, and other travel service providers. Additionally, through the code-share arrangements

previously discussed, airlines have entered into frequent flyer arrangements with certain code-share partners and issue miles for travel on each other's airlines. Please refer to Chapter 3 for further discussion of frequent flyer programs and related accounting considerations.

Airline Investments

Aircraft Fleet

1.60 The airline industry is characterized by substantial aircraft investment. Because of traffic projections and lengthy production schedules, most airlines acquire aircraft fleets over a number of years. The large manufacturers typically require progress payments (purchase deposits) during the manufacturing period, with balloon payments upon delivery. New fleet acquisitions also require a significant capital outlay for spare parts to support the aircraft. The rapid development of technological advances and substantial plant and equipment investment needs have created large capital requirements, which cannot be met by internal funding alone. Cyclical earnings also hamper the ability of some airlines to raise money through equity and unsecured debt issues. This has increased reliance on secured debt, leasing, and other similar forms of financing. The large financing requirements that are characteristic of the industry make ownership costs (depreciation, interest, and rent expense) a major component of an airline's fixed costs.

1.61 The number of aircraft types in a fleet can affect many aspects of an airline's operating expenses. A simplified fleet can help an airline save on maintenance and training costs because mechanics and flight crews need to be knowledgeable on fewer aircraft types. In addition, spare parts inventory requirements are reduced because the airline needs to hold parts for fewer aircraft types.

1.62 The age of the aircraft is also important because a younger fleet tends to be more fuel efficient and requires less maintenance than an older model aircraft. Please refer to Chapter 4 for further discussion of airline fleet and related accounting considerations.

Airport Facilities

1.63 Local governments play a major role in air transportation by financing, owning, and operating terminal facilities necessary for air travel. Generally, the cost of terminal facilities and their maintenance are reimbursed by the airlines through landing fees, charges for terminal facility rentals, and passenger facility charges (PFCs). Please refer to Chapter 10 for further discussion of PFCs and related reporting requirements.

1.64 In some cases, airlines initially fund construction and modifications and are later reimbursed from proceeds of bond issues, rental credits, or both. Municipalities, through airport authorities, often finance the acquisition and construction of various facilities and equipment by issuing special facility revenue bonds. An airline will often guarantee these bonds and enter into a special facility lease agreement as the lessee to use the facilities and equipment constructed with the proceeds of the bonds. Please refer to Chapter 6 for further discussion of airport financings and related accounting considerations.

1.65 Ground handling services typically can be categorized as follows: public contact, under-wing ground handling, and complete ground handling. Public contact services involve meeting, greeting, and serving customers at the check-in counter, gate, and baggage claim area. Under-wing ground handling services include marshaling the aircraft into and out of the gate, baggage and mail loading and unloading, lavatory and water servicing, de-icing, and certain other services. Complete ground handling consists of public contact and under-wing services combined.

Fuel Facilities

1.66 Airlines usually participate in numerous fuel consortiums with other carriers at major airports to reduce the costs of fuel distribution and storage. Agreements govern the rights and responsibilities of the consortium members and provide for the allocation of the overall costs to operate the consortium based on usage. The consortiums (and in limited cases, the participating airlines) have entered into long-term agreements to lease certain airport fuel storage and distribution facilities that are typically financed through tax-exempt bonds (either special facilities lease revenue bonds or general airport revenue

bonds) issued by various local municipalities. Please refer to Chapter 6 for further discussion of fuel facilities and related accounting considerations.

Routes, Slots, and Gates

1.67 Certain very high density airports have a fixed number of takeoff and landing times (slots) available, as designated by the U.S. government to avoid excessive congestion. The rights to these slots may be sold or traded by the airline that owns the rights to the slots. These transactions generally include the sale of a gate or access to gates. Slots and gates, particularly those in high demand, have value and represent intangible assets.

1.68 Intangible assets also typically include routes. Traditionally, foreign countries limited access to routes from the United States to protect their national airlines from too much competition. International route authorities and access to the airports by U.S. carriers are governed by bilateral aviation agreements that can limit the number of airlines that may provide service to certain airports and can restrict service by aircraft types, frequency, or destination. Please refer to Chapter 6 for further discussion of routes, slots, and gates and related accounting considerations.

Insurance

1.69 Insurance programs for airlines normally include aviation, hull, and terrorism insurance; building and contents; executive protection programs; fiduciary liability; home, kidnap, and ransom insurance; directors' and officers' liability; group and workmen's compensation insurance; and other typical insurance programs. Although most of these programs are comparable to the insurance programs of other industries, there are several unique insurance programs directly related to the airline industry, including aviation, hull, and terrorism insurance, that are discussed in the following sections.

Aviation Insurance

1.70 Aviation insurance for passenger liability relates to the coverage of risks associated with providing air transportation services to passengers and residual risks to people and property on the ground. This includes catastrophic accidents as well as routine passenger-related claims. Environmental coverage within aviation is typically extremely limited.

1.71 Aviation insurance, in general, is provided by a front, or lead insurer, that provides claim handling services and administrative support. In some cases, lead insurers are paid a fee for services rendered in addition to their syndicated share of insurance premiums. Additional insurers subscribe to this lead policy to complete the overall offering of insurance to spread the catastrophic risk of accidents over a larger capital base, much like banks syndicate significant loans to limit default exposure. A major airline may have 10 to 20 insurers subscribing to a lead policy, providing varying levels (1 percent to 20 percent) of financial capacity in support of the overall insurance limit. The limit of insurance offered collectively by the syndicate ranges from $500 million per accident or incident for smaller regional airlines to well in excess of $1 billion for major U.S. airlines. All airline aviation insurance is purchased through insurance brokers, which are typically compensated either on a commission basis on premiums paid or on a fee basis directly from the airline.

1.72 Premiums are normally determined on the basis of a rate per passenger mile or departure flown. The insurance rate charged is normally fixed, while the exposure basis, such as passenger miles flown, departures, cargo ton miles, passenger enplanements, or other measure of flying activity, is variable. Aviation insurance premiums are typically established as a deposit premium at the beginning of the policy year based on management’s projections of flying activity and are adjusted at policy year end based on the actual flying activity, with a resulting refund or additional premium due.

Hull Insurance

1.73 Hull insurance covers damage to flight equipment, spare parts, and aircraft in the airline's care, custody, and control (including when the airline provides maintenance for fee to other airlines) while in the air or on the ground. Hull insurance rates are normally based on dollar value of insured equipment. The insured value of equipment may be determined in several ways: net book value, replacement cost, estimated fair value, or as contractually defined in operating or financing leases (in the event of total loss). The rate applicable to insured value of equipment is normally fixed; however, premiums are also adjusted at year end based on actual values insured during the course of the year to reflect deliveries of new aircraft, sales, or material adjustment in asset valuation (such as what occurred following the events of September 11, 2001, in terms of significant reduction of aircraft values industry wide). Typically, there is a reduced premium rate for "grounded" or excess aircraft not in use.

Terrorism Insurance

1.74 The following paragraphs describe terrorism insurance and are reproduced with permission of the publisher, International Risk Management Institute, Inc., Dallas, Texas, from *Terrorism Insurance: What Risk and Insurance Professionals Must Know*, copyright International Risk Management Institute, Inc. Further reproduction prohibited. For subscription information, phone 800-827-4242. Visit www.IRMI.com for reliable and practical risk and insurance information.

Terrorism insurance for airline hull and liability (also referred to as war risk insurance) was a relatively inexpensive coverage prior to September 11, 2001. For major U.S. airlines, the total cost of war risk for hull and liability was 2 to 4 cents per passenger, or perhaps $30 to $50 million for the US airline industry in total. It was sold as a stand-alone insurance program for hull war risk, and on the liability side, as an endorsement to an airline "all risk" policy. Both coverages contained a 7 day notice of cancellation,

typically used to re-price the coverage, or restrict coverage for certain geographic hot spots.

The week after the terrorist attacks of September 11, 2001, aviation insurers worldwide issued notice of cancellation to all commercial airlines. Insurers offered reinstatement terms, but at dramatically higher prices (i.e., $1.25 per passenger, or approximately $750 million premium annualized for all U.S airlines), plus reduction of limits to a standard $50 million as respects damage to people and property on the ground to reduce future exposures to mass ground casualties. Due to the contractual obligations of the airlines, as well as insurance limit requirements imposed for flying into certain countries, the insurance limits offered by the market were not sufficient for airlines to fly, in effect grounding airlines worldwide.

Various countries responded to this crisis in different ways. In some countries, the government provided indemnification for non-passenger losses. In others, particularly smaller countries whose indemnification would not be considered sufficient financial security, the government forced the airlines to purchase what limited excess insurance was offered, adding yet another extreme cost to the airline. Other countries, including the United States, enacted legislation to provide insurance to close the gap, charging a premium for this coverage. The Airline Stabilization Act of (September) 2001 authorized the Federal Aviation Administration (FAA) to provide excess insurance above the $50 million commercially provided limit, which allowed U.S. airlines to continue to operate. The Act also capped third party liability claims brought in the U.S. to $100 million for a terrorist event.

For U.S. air carriers, this system stayed in place until December of 2002, when the Homeland Security Act authorized the FAA to broaden its coverage beyond third party liability to provide hull, passenger and third party war risk insurance for the airlines for a defined premium, along with reauthorizing the $100 million cap.

1.75 The FAA is currently providing war risk hull loss and passenger, crew, and third-party liability insurance through December 31, 2007 as required by the Homeland Security Act of 2002 and in anticipation of enactment of the Departments of Transportation, Housing and Urban Development, and Related Agencies Appropriations Act 2008 that also will require an extension of coverage of a war risk insurance policy for the period September 1, 2007 through December 31, 2007. While the price of commercial insurance has declined since the premium increases immediately after the events of September 11, 2001, if the U.S. government does not extend its insurance policy it will have a significant effect on the airlines.

Proposed AICPA Audit and Accounting Guide

Airlines

Chapter 2

General Auditing Considerations

Omitted from the exposure draft.

Proposed AICPA Audit and Accounting Guide

Airlines

Chapter 3

Marketing, Selling, and Providing Transportation[2]

Introduction

3.01 Airline revenue is derived primarily from the carriage of passengers, cargo, and mail. The primary emphasis of this chapter is on passenger revenue, which is a passenger carrier's main operating revenue, and frequent flyer programs (FFPs), which are generally a passenger carrier's primary marketing activity. Discussions of revenue recognition issues related to air cargo and regional carriers are included in Chapters 8 and 9, respectively.

3.02 Revenue recognition generally involves consideration of two factors: (*a*) being realized or realizable and (*b*) being earned.[3]

2 This chapter contains numerous references to fair value. It does not reflect, however, the requirements of Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*, which provides enhanced guidance for using fair value to measure assets and liabilities. FASB Statement No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances.

FASB Statement No. 157 does not apply under accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value, including Emerging Issues Task Force (EITF) Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," which is also referred to in this chapter.

FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. This guide will be updated at a future date to reflect changes arising from FASB Statement No. 157.

3 FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83.

3.03 Because airline tickets are usually sold in advance of the transportation date, the ticket sale date seldom coincides with the revenue recognition date, which is also referred to as the service date. Therefore, the task for airline revenue accounting is twofold:

- To record unearned revenue (air traffic liability [ATL]) when a ticket is sold and scheduled service is at a later date
- To recognize revenue when the carrier provides the transportation service and thereby completes the earnings process

3.04 Revenue accounting is the most complex accounting area for airlines and their auditors. Many changes have occurred in the airline industry since 1980. Before 1980, airlines used two primary methods to recognize revenue on tickets, generally referred to as the *sales/use match* and *sampling* methods. The primary difference between the two methods is that the sales/use match method matches transactions and recognizes revenue at the ticket level (based on tracking and reporting of the actual activity related to each ticket sold), while the sampling method treats the total unearned revenue as a pool and focuses on valuing coupons (also referred to as a *segment* or one *leg* of the ticket) and recognizing revenue based on that valuation. Both methods were acceptable and, after the application of appropriate control processes, accomplished substantially the same result. Since 1980, new information technology systems, most of which are based on some form of the sales/use match system, have been developed to better meet airlines' revenue accounting needs. During the decade after deregulation, ticketing and fare rules became more complex, as airlines tried to restrict access to their lowest fares, resulting in Saturday-night-stay requirements, nonrefundable tickets (including exchangeable tickets that are not refundable), and change fees being applied to certain ticket exchanges. In addition, during this period FFPs became a primary sales and marketing tool used by airlines to promote customer loyalty. The accounting for FFPs is still one of the most complex and subjective areas in airline accounting. Finally, with the expansion of low-cost carriers in the late 1990s, fare rules in some cases simplified and low-cost airlines further simplified their processes by, among other things, not interlining with other carriers, not using travel agents or others to sell their tickets, and eliminating ticket variables by generally using nonrefundable but exchangeable tickets.

3.05 This chapter provides information about the processes that occur in the complex and varied airline revenue accounting systems of today.

Process Description

Airline Pricing

3.06 An airline's pricing strategy has a significant effect on its revenue. Pricing strategy depends on a number of factors including the type, number, and configuration of aircraft (single class versus multiple classes), marketing alliances, and route structure (hub and spoke or point to point).

3.07 Pricing is usually a function of the overall health of the economy, passenger demand, and industry capacity. A challenge for the industry is to meet the demand for air travel without adding excess capacity, which would affect pricing negatively. Airlines must also survive periods of slowed economic activity, which also tends to lessen demand. Because air travel is largely a commodity-type business, airlines usually attempt to ensure that the pricing of their product is competitive. This is particularly important because most travel is sold through Global Distribution Systems (GDS) or other forms of electronic distribution (for example, Internet sites of the airline and third-party travel agents) that allow travelers to easily access and compare pricing information.

3.08 There are other factors involved in determining pricing. One key factor is an airline's management philosophy. Some airlines focus on high passenger volume at lower prices while others focus on so-called premium passengers and accept lower load factors. Philosophies are subject to variation because airlines may purposely keep their fares low or drop their fares further to generate more revenue. If those airlines are large enough competitors, other airlines may match their fares across the board to remain competitive. If it is a smaller airline reducing fares, other airlines can match selectively in order to minimize revenue dilution. As low-fare, low-cost airlines continue to grow, market share pricing trends continue to move to simplified low fares across most markets.

Sources of Airline Revenue

3.09 Traditionally, approximately 90 percent of passenger carriers' operating revenue (excluding subsidies) has been derived from passenger operations, including revenue from upgrades from one class of service to another and preferred seat assignments. This revenue is classified as passenger revenue. Other operating revenue is derived from air cargo operations, principally air freight and mail services. Additional sources of other operating revenue include sales of goods and services including food, beverages, headsets, frequent flyer miles, fuel, contract maintenance, passenger handling, and paper ticket and excess baggage fees. Many airlines also charge airline transaction fees for services performed, such as ticket change fees and reservation fees (for using an agent and not the Internet). These fees are classified either as passenger or other operating revenue. Some of these items are discussed in greater detail subsequently in this chapter.

Industry Resolutions

3.10 Two main airline governing bodies establish industry specifications and guidelines for reservations and ticketing. The Air Transport Association of America (ATA) publishes the Passenger Traffic Resolutions Manual (PTR), which contains the reservation, ticketing, and customer handling requirements for paper and e-tickets. The International Air Transport Association (IATA) publishes the Multilateral Interline Ticketing Agreement (MITA), which is used to apply pricing and prorate values to international itineraries. Most airlines are members of ATA or IATA or both. However, even nonmember airlines based in the United States adhere to the ATA's PTR in their dealings with other airlines.

Ticketing

Ticket Types

3.11 A ticket for air transportation may be issued weeks or months before the scheduled departure date. Airlines sell two types of tickets: paper tickets and electronic

tickets (e-tickets). A paper ticket consists of multiple coupons indicating the passenger's itinerary. One coupon is the *auditor's coupon,* which is the initial document used to record a sale. Additional coupons, referred to as *flight coupons*, represent each flight segment (leg) of the passenger's itinerary. Flight coupons are lifted (detached from the ticket booklet) by the carrier providing the transportation service at the boarding point as evidence of the service rendered, although today this process is entirely electronic for the vast majority of ticket sale and boarding transactions.

3.12 An e-ticket reflects the passenger's itinerary in electronic form. Like paper tickets, e-tickets contain information for each flight segment of a passenger's itinerary. In all cases, the airline's host reservation system or GDS produces an e-ticket sales record for each sale transaction, and the airline's revenue accounting department receives and processes the e-ticket sales records. Boarding documents are issued for e-tickets, and the carrier documents transportation service at the boarding point by either collecting boarding documents or scanning them as evidence of the service rendered.

Ticket Classifications

3.13 Tickets are usually sold in two general categories of fare rules: (*a*) refundable/unrestricted fare types or (*b*) nonrefundable/restricted fare types. An unused ticket (either entire ticket or partially used ticket) for a scheduled flight may expire unused, eventually be refunded, used on another carrier for the same itinerary, rerouted and reissued for a different flight, or otherwise become invalid for travel. A refundable/unrestricted ticket may be returned for a refund, used, or exchanged with no or few limitations. A nonrefundable/restricted ticket has a number of restrictions on its use and will rarely, if ever, result in a refund to the customer. Many airlines also charge fees (ranging from $30 to $100) for making any change to restricted tickets, referred to as *change fees*, in addition to charging for differences in fares. Also, many airlines may not permit any further use of the ticket after the scheduled flight date if the passenger has not called ahead to cancel the reservation and has not flown any segment or leg of the scheduled itinerary. All fare rules pertaining to the fare type are listed in the airline's fare

rules or in their contract of carriage. A ticket (entire ticket) is generally valid for one year, with the specific period identified in a statement printed on the ticket or e-ticket receipt. Partially used nonrefundable tickets generally are invalid if not used on the scheduled date of travel. All tickets have an expiration date at which time they become invalid.

Interline Ticketing

3.14 Some airlines issue only tickets that may be used for transportation only on the airline's own flights and provide transportation only to passengers holding tickets issued by the airline. Those airlines are referred to as noninterline airlines. Other airlines have agreed to provide transportation interchangeably with other carriers. Those airlines are referred to as interline airlines. A ticket sold by an airline in which transportation on all flight segments will be provided only by that airline is referred to as an online (OL) sale. A ticket sold by one airline that includes flight segments to be traveled on another airline is referred to as an off-line or other airline (OAL) sale. One ticket can include several flight segments, which may include flights on various carriers. The carrier that issues the ticket, known as the OL carrier, collects the total fare from the passenger. The OL carrier then settles the fare with the other carriers on which transportation is scheduled, known as OAL earners, on the basis of interline agreements (described in a subsequent section of this chapter). Some airlines have bilateral interline e-ticket agreements with OAL carriers whereby the usage of OAL segments is processed and settled electronically (described in a subsequent section of this chapter).

Sales Reporting

3.15 Tickets may be sold by airline ticketing agents at airports or ticket offices, in reservation centers, over the Internet, or by domestic or worldwide travel agents. Tickets are generally paid for in cash, by check, by various credit cards, or by the exchange of a previously purchased ticket. In the United States, credit card sales generally represent a significant portion of new sales transactions. See the "Credit Card Holdbacks" section of this chapter for a discussion of accounting and reporting of credit card holdbacks.

Airline Sales

3.16 A significant portion of an airline's operating revenue is generated through sales made to customers over the phone through the airline's reservations center or via the airline's Internet Web site. Customers may also purchase tickets at airline locations, including airport stations and city ticket offices. The majority of tickets are e-tickets. All airline sales are controlled and processed in a similar manner.

3.17 Airline sales and refund activity are reported to revenue accounting. The reporting can be accomplished via online computer processing, with each ticket priced and recorded automatically. Reporting can also be performed manually by preparing daily ticket sales reports, which detail sales by ticket number. Under both systems, auditor's coupons and e-ticket sales records are sent to revenue accounting for verification.

3.18 The accounting entry for airline sales recognizes cash received and credit card receivables with corresponding credits to the ATL and related transportation tax liability accounts.

Direct Reporting Sales

3.19 Airlines can offer ticketing capability (booking, ticketing, direct reporting, and settlement) directly to businesses, travel agencies, or other industry-related entities. These ticketing transactions would typically be processed by the airline's host reservations system, and tickets may be issued through various Web sites and Internet connections.

3.20 Direct report sales are generally embedded in the airline's own sales and reporting process and processed and recorded as airline sales.

Travel Agency Sales

3.21 A large portion of airline industry ticket sales (other than on low-cost carriers) is generated through travel agencies. Accordingly, the settlement of sales proceeds due the airlines and commissions due the agencies is an important aspect of revenue accounting.

3.22 The processing of sales made by U.S. travel agents and the related accounting for such sales is conducted under rules established by the Airlines Reporting Corporation (ARC), which is an entity owned and operated by the airlines to facilitate travel agency reporting. Under ARC's carrier and agency agreements, agency area settlement banks serve as intermediaries between domestic travel agencies and airlines for the processing and settlement of sales records. International travel agency sales are processed through a regional or country bank settlement plan (BSP). International travel agency sales processing is similar to ARC processing.

3.23 A travel agency indicates the airline to which a ticket sale is to be credited by the coding of designated or undesignated ticket stock. The travel agency also includes the tax and commission codes on the auditor's coupon or e-ticket sales record. The agency uses ARC's Interactive Agent Reporting tool (IAR) to finalize and process its sales report to ARC in accordance with a reporting schedule. ARC transmits the processed sales records to each airline electronically, generally without paper coupons or any other support. The settlement between the agencies and the airlines is accomplished according to the schedule determined by ARC.

3.24 The area settlement bank processes these documents and records and prepares invoices and reports necessary for settlement, including travel agency sales reports by airline and by agency. The bank makes the settlement for the tickets sold by the agencies for those airlines with accounts at the bank. The bank also submits invoices and associated charges to the respective credit card processors, which calculate the net amount of the settlement (sales less credit card fees) and make direct payment to each airline.

3.25 The accounting entry for travel agency sales recognizes a receivable, net of the related fees and commissions, with corresponding credits to the ATL and related transportation tax/fee accounts. Carriers generally recognize commissions (agency and credit card) as a prepaid expense and then subsequently recognize expense when transportation service has been provided.

Sales Audit

3.26 A carrier's audit of sales can commence when all documents and records are received by the revenue accounting department. The degree of this audit function may range from zero to 100 percent and depends on the airline's accounting policies and processing sophistication. The audit may include one or more of the following: verification of ticket number sequence, agreement of cash and charge sales with the sales reports, and, in some systems, ticket pricing and completeness of paper and e-ticket sales files. Fare differences noted during the audit can be charged back or credited to the travel agencies in the form of debit and credit memos. Accounting for these memos results in corresponding debits or credits to the ATL and related transportation tax accounts.

Payment Processing

3.27 Accepted forms of payment are cash, check, and credit card. Cash or checks are reported by the airline’s ticket sales office via a deposit slip that is verified against sales reports. Carriers receive credit card receipts from each participating credit card company. The funds are received via wire transfer and are verified against the sales and refunds submitted daily to each credit card company.

Credit Card Holdbacks

3.28 Generally, the airline industry uses credit card processors to handle all the details of processing credit card transactions between the cardholder, the air carrier, and the issuing bank. The issuing bank maintains a cardholder’s credit card account and pays out to the air carrier’s account when the cardholder makes a credit card purchase.

3.29 Once billed, credit card transactions are subject to dispute by the cardholder. When a transaction is disputed by the cardholder, the amount of that transaction is subject to chargeback and becomes contractually recoverable from the airline.

3.30 In the airline industry, tickets for air transportation are often sold weeks or months before the scheduled departure date. During the period between sale and departure date, the credit card processor relies on an air carrier's ability to provide transportation or the proceeds from sales transactions to reduce the risk of cardholder chargebacks. In the event an air carrier files bankruptcy, ceases operations, and fails to provide transportation to the ticketed passenger, the credit card processor is responsible for reimbursing the cardholder. This reimbursement becomes an unsecured claim on the estate of the bankrupt carrier.

3.31 To mitigate this risk, credit card processors may hold back certain proceeds from a carrier's sales transactions or require a carrier to deposit funds in an account held for the benefit of the credit card processor to cover any possible chargebacks or other disputed charges that may occur. Depending on the terms and conditions of the underlying credit card processing agreement, this holdback or reserve would generally be recorded by the air carrier as either accounts receivable or restricted cash. In addition, a traditional credit card holdback agreement—one that holds back some or all of the receivables due to the airline until the transportation is provided—would normally be reflected as a reduction of operating cash flows.

Travel Agencies

3.32 ARC acts as a clearinghouse for the U.S.-based travel agency industry to ensure timely reporting and settlement with travel agencies. ARC performs a variety of functions, including receiving sales reports and funds from member travel agencies on a daily basis. ARC then processes the credit card sales to credit card companies, which later remit payments directly to each carrier via wire transfer subject to credit card

holdback agreements previously discussed. ARC combines all other travel agency transactions and then sends sales information and remits payments directly to the participating airline.

Other Airlines

3.33 The Airlines Clearing House (ACH) was established to expedite settlement of interline accounts between member carriers. Each member airline submits billing documentation once a month to the ACH. Debtor airlines are required to make funds available and subject to disposition of the clearing bank in an amount equal to or in excess of the amounts required for settlement. The clearing bank effects settlement by debiting the accounts of the debtor airlines and crediting the accounts of the creditor airlines with the net debit or credit balance as specified on the respective settlement documents.

Passenger Travel

3.34 Passengers present their paper tickets to the airline when checking in for their scheduled flight. Passengers with e-tickets may initiate check-in through the Internet, at a kiosk, or at a ticket counter. In all cases, the passenger is issued a boarding pass.

3.35 At the gate, as passengers enter the aircraft, the boarding agent collects the boarding passes or otherwise documents the boarding (for example, in some cases the boarding agent scans boarding passes issued for e-tickets without physically collecting them). Prior to departure, the agent balances the total number of passengers boarded with the number of collected boarding passes and otherwise documented boardings. Upon departure, the flight is closed out by the boarding agent, and the e-tickets are recorded as used in the reservation system. Generally, the status of an e-ticket changes from "okay" (meaning available for use) to "checked-in" and then to "used" once the flight has departed. The completed flight report contains the lifted flight coupons, boarding passes,

and e-ticket boarding documents collected or processed as passengers entered the aircraft. The flight report is sealed and sent for processing to revenue accounting.

3.36 Lifted flight coupons are scanned or keyed for entry into the revenue accounting system. Used e-ticket records are received from the airline's host reservation system and loaded into the revenue accounting system as well. Together, the paper and e-ticket records are recognized as earned revenue, whether they originate as OL or OAL sales.

Refunds, Exchanges, and Reissues

3.37 Several types of refunds and exchanges can be made for an airline ticket. They include full and partial refunds, reissue/even exchanges, reissue/refunds, and reissue/additional charges. All refunds are processed against the original form of payment and adhere to all refund and exchange rules for the fare. If a refundable ticket is surrendered in exchange for a ticket for a flight on a different route or on a different airline that carries the same fare, a reissue/even exchange is required. If a refundable ticket is surrendered for another ticket with a lower fare, a reissue/refund is required. If a refundable ticket is surrendered for a ticket with a higher fare, a reissue/additional charge to the passenger is required. If the original ticket is nonrefundable or restricted, a change fee and change in fare are frequently required in order to exchange the nonrefundable ticket for another ticket. However, refunds are issued rarely, if ever, on nonrefundable tickets.

3.38 Refunds and exchanges for refundable and nonrefundable tickets can be executed at company locations (airport or ticket office), by travel agencies, by the airline refund department, or by other airlines. Depending on the airline's policy, company locations may issue checks or credit directly to the customer or take applications for refunds. If it is a paper ticket transaction and a new ticket is required, the old ticket is collected from the passenger. The old ticket, the auditor's coupon of the new ticket, and refund checks or refund applications are batched and submitted to revenue accounting with the daily ticket sales report documents. The revenue accounting department sorts the refund documents,

logs them in a control record, and sends them to refund accounting for pricing, auditing, and issuance of refunds.

3.39 If the refund or exchange for refundable and nonrefundable tickets is requested on an e-ticket, a refund or exchange entry is processed for the e-ticket record in the host reservation or in the GDS, causing the e-ticket to be cancelled in the reservation system. The e-ticket record is then sent electronically to the revenue accounting department for processing.

3.40 If a carrier executes an exchange for an OAL ticket, that carrier then bills the coupon value of the redeemed ticket back to the carrier that sold the ticket via the interline billing process. This refund item is audited by the OAL carrier as part of the interline settlement process discussed subsequently in this chapter.

3.41 Refunds and exchanges for refundable and nonrefundable tickets are recorded as adjustments to the ATL, accounts receivable, and cash accounts as part of the company, travel agency, and interline sales entries.

Statistics

3.42 Generally, the revenue accounting department is responsible for compiling the airline's traffic and passenger statistics. The statistics may be for internal use or for financial, Department of Transportation (DOT), or other governmental reporting. Traffic statistic records should agree to other compiled operational statistics, such as on-time performance. See the "Analytical Procedures" section in Chapter 2 for an expanded discussion of statistics.

Air Traffic Liability

3.43 When a passenger ticket is sold, the selling carrier records a cash receipt or account receivable and unearned transportation revenue. ATL is the value of unused

transportation sold by the reporting air carrier. This includes the liability for transportation to be provided by the carrier selling the ticket, as well as a liability for transportation that may be provided by other air carriers.

3.44 Under the umbrella of the ATA, members are permitted to establish procedures for handling interline operations. The details for these procedures are set forth in three primary interline agreements: ATA ticket and baggage agreement, the IATA bilateral agreement, and a multilateral agreement. Some airlines participate in one or more agreements. The agreements cover interline passenger ticketing, cargo, and baggage procedures; specify the source of accepted published fares; and describe the process of settling funds between participating airlines. The interline agreements exist to simplify the ticketing process for air travelers and to minimize the number of tickets necessary to complete an itinerary that involves more than one air carrier.

3.45 Under the interline agreements, the air carrier providing the first flight shown on a ticket for a multi-carrier itinerary is allowed to issue a ticket for the entire trip and collects the total fare from the passenger. As a general practice, however, the carrier making the reservation issues the ticket even if it is the second carrier. Airlines have many marketing alliances with other carriers, such as code-sharing arrangements. In the case where two carriers share a marketing code, the marketing carrier (that is, the carrier whose code is on the flight) generally issues the ticket. The issuing carrier then prorates the fare among the carriers providing service on the itinerary based on the interline agreements in effect. Proration is a method of dividing the total fare among carriers according to the joint fares published in the Industry Prorate Manual or in accordance with existing agreements between code-share or alliance partners, which are frequently referred to as special prorate agreements (SPAs).

3.46 As a result, the total value of the ticket is recorded in the ATL account of the issuing carrier and includes both the issuing carrier's liability to provide air transportation to the passenger and its liability to other carriers for their portion of the itinerary. While part of a carrier's ATL account represents interline amounts payable to other air carriers,

other air carriers are also issuing interline tickets on which the carrier has an obligation to provide service.

3.47 The carrier reduces unearned revenue in the ATL account and recognizes earned revenue from OL sales when transportation service is provided. The basic methods of accounting and invoicing other airlines after transportation service has been provided and other revenue accounting issues are described in the following sections of this chapter.

Revenue Accounting Issues

General

3.48 In December 2003, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition.* SAB No. 104 provides the SEC's views on applying generally accepted accounting principles to revenue recognition in financial statements and was not intended to change current guidance in the authoritative accounting literature.

3.49 The Financial Accounting Standards Board (FASB) has a revenue recognition project on its agenda. The objective of the project is to develop conceptual guidance for revenue recognition and a comprehensive accounting standard on revenue recognition based on that guidance. Practitioners should stay alert to further developments. Revenue accounting in the airline industry has evolved over a number of years and is based on existing accounting principles and related guidance. The following sections describe current revenue accounting methods, processes, and issues and include an example passenger revenue recognition model.

Revenue Recognition Methods

3.50 Lifted flight coupons and other electronic evidence of boarding (collectively referred to as *coupons*) are used as the basis for recording revenue. Tickets sold by the carrier providing transportation and used by the passenger are referred to as *OL coupons*.

Tickets sold by other airlines and used by passengers on the operating airline are referred to as *OAL coupons*. Both OL and OAL coupons are evidence of passenger travel. OL and OAL coupons represent revenue to the carrier for the transportation service provided. If the carrier uses a sales/use match system, OL coupons support the credit entry to earned revenue. If the carrier uses a sampling method for recognizing revenue, OL coupons are surveyed to determine the credit entry to earned revenue. See the "Accounting" heading in the "Interline" section of this chapter for a discussion of revenue recognition for OAL coupons.

3.51 The two basic systems used for calculating earned revenue—the sales/use match and the sampling method—are described in the following sections. However, with the advent of technology, few airlines continue to use a sampling-based method for revenue recognition. The preferred approach for calculating earned revenue is the sales/use match method. For purposes of this discussion, a *ticket* is defined as equaling the sales value of the entire transaction, excluding passenger taxes and fees as discussed subsequently in this chapter (that is, the combined value of all individual flight segments on an itinerary). A *coupon* is defined as the value associated with each individual flight segment and can be evidenced by lifted flight coupons and other electronic evidence of boarding the individual flight segment.

Sales/Use Match Method

3.52 The principal objectives of the sales/use match method are to record all sales information by ticket and to match the usage of all recorded tickets by coupons. In this kind of system, all OL tickets issued are recorded in the ATL account and tracked by ticket number, transaction control number (TCN), or both. OL coupons are matched against the recorded tickets, and the coupon value is deducted from ATL and added to earned revenue. Interline billings to other airlines represent usage of OAL coupons and are recorded as earned revenue and accounts receivable. Interline payable billings by other carriers represent a usage of OL coupons, which are matched against the recorded tickets and deducted from the ATL account upon payment to the other carrier.

Adjustments to the ATL account are made periodically for unmatched tickets and coupons (usage and sales), valuation differences, and ATL breakage (described subsequently in this chapter). Generally, in most sales/use match systems, the ticket amounts are determined from a sales-type record or TCN, and the itinerary is prorated by the type of fare construction and fare paid. When prorating the itinerary, the objective is to value each coupon based on its relative fair value in accordance with Emerging Issues Task Force (EITF) Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." These values are later used to determine revenue to be recognized upon travel.

Sampling Method

3.53 The objective of the sampling method is to recognize revenue on the basis of a survey of OL and OAL coupons for the period. There are two attributes for which a sample of coupons may be tested: number of revenue passenger miles (RPMs) or number of revenue passengers. If the RPM attribute is used, a sample of the dollar value of coupons is accumulated and divided by RPMs flown to produce an average yield per RPM. Average yield calculations are usually done for each segment (that is, origin and destination cities) in the airline's system. These average yields are accumulated for the number of passengers in the sample thus creating a weighted average yield for each segment. These weighted average yields are then multiplied by the total number of RPMs flown by the carrier for each segment to determine earned revenue. The number of passengers attribute system develops an average fare per passenger from the sample. Earned revenue is then determined by applying this average fare to the number of passengers transported for the period. The average yield per RPM is the more common attribute used for sampling systems and is more accurate than using an average fare.

3.54 Carriers use various methods to sample lifted coupons, for example, testing all lifted coupons with a number ending in a selected digit. If the airline uses statistical sampling methods, the independent auditor must be satisfied that the sampling plan has

statistical validity, that it has been applied properly, and that the resulting precision and reliability, as defined statistically, are reasonable in the circumstances.

3.55 Under the sampling method, all OAL coupons are initially recorded in the ATL account (in which OL tickets and coupons were previously recorded). All coupons (OL and OAL) are processed for statistical data required by the DOT and for the required sampling data. Earned revenue is recognized on the basis of the sampling data for all coupons and is deducted from the total of tickets recorded in the ATL account. All OAL coupons are recorded in the ATL account to determine a total of all coupons sold by other airlines, from which revenue can then be recognized. Interline payable billings are deducted from the ATL account when they are paid. Differences, such as those arising from clerical inaccuracies between amounts originally recorded and amounts billed, may be rejected and rebilled or written off if the originally recorded fare was incorrect.

Interline

Accounting

3.56 OAL coupons are evidence of travel that supports interline receivables and revenue. The tickets were sold by another carrier and used on what is referred to as the *operating carrier*. The OAL coupons are processed to record revenue and to initiate interline receivable billings. OAL coupons are assigned a billing value in order to create interline billings to collect earned revenue. Some airlines assign a billing value to all of these coupons (this approach is referred to as *nonsample interline billing*), while others assign a billing value to a sample of coupons selected based on ticket number digits, which are published monthly by various airline agencies (this approach is referred to as *sample interline billing*). Frequently in sample interline billing, a standard pricing value is assigned to OAL coupons by the airline pricing system, which is later adjusted by a depressant (see discussion in the next paragraph regarding the term *depressant*). The pricing approach to be applied is agreed in advance between the two carriers. Pricing of coupons can be done manually, but for most airlines it is done via computer processing

systems using a TCN record. A TCN is created when the host or GDS system generates a paper or e-ticket. The TCN record is received the next day by the issuing airline and by the airline that has a scheduled travel segment on an OAL ticket. The TCN can be used to reconcile the individual coupon values from the GDS (determined in the pricing process) to use in the airline's proration subsystem.

3.57 The statistical sampling size and methodology are outlined in the ACH Manual of Procedures and IATA Revenue Accounting Manual (RAM). In general, however, a billing airline that intends to bill actual fares runs the OAL coupons through a pricing system in an attempt to obtain the correct value of each ticket. The billing is then subject to auditing by the billed airline. In an attempt to simplify the process, some airlines bill at a local fare less a calculated depressant. The depressant is based on a historical ratio of standard local fares to settled fares and is used to adjust the current month's interline billings. The coupons within the sample are audited by the billed airline, and the billing adjustment is applied to the entire billing amount. Airlines need to consider providing reserves if history indicates that interline billings are frequently adjusted downward upon audit because audits can take up to six months.

Settlement of Interline Balances

3.58 To aid in billing interline receivables, the airline industry has established clearinghouse settlement plans in which most carriers participate. The settlement procedures are described in the interline agreements. The ACH performs this interline settlement function for most western hemisphere carriers, and the IATA Clearing House performs this function on a worldwide basis. Some airlines are members of both clearinghouses.

3.59 Airlines transmit summaries of their interline invoices to the clearinghouse, which tabulates and reports the balances of accounts receivable and accounts payable for each member airline on a semimonthly basis. The net balances are calculated monthly, and settlement is made through each participating airline's account. Each airline is also

responsible for preparing invoices that detail the airline billed, the amount invoiced, and the tickets that were assigned a billing value. The invoice, including the supporting lifted paper tickets and e-ticket listing, is sent monthly to the appropriate airline.

3.60 Each carrier is responsible for auditing the interline billings it receives. The audit is performed after settlement through the clearinghouse. Any differences noted in the audit are rejected and rebilled to the appropriate carrier in subsequent months. The percentage of tickets selected for audit (sampling or 100 percent) is a matter of the agreement between the airlines. If a sample is used, the sampling method and size of sample are agreed upon by each airline clearing with the billing carrier.

3.61 First and final settlement is a process that was developed by the global airline alliances established in the late 1990s as a way of eliminating many of the inefficiencies in the process. In first and final settlement, two carriers agree to an allocation of the price between the different segments at the time of ticket sales, thus avoiding all of the subsequent billing and rebilling that occurs under the traditional airline interline model.

Air Traffic Liability Verification

3.62 The ATL balance for the sales/use match method of revenue recognition generally is verified monthly by reconciling ticket-level detail contained in unearned revenue subledger files to the general ledger balances in ATL. A number of common reconciling items exist in this reconciliation, primarily unmatched usage, accrued sales, and ATL breakage, which are described in detail in the sections that follow.

3.63 In the verification of ATL account under the sampling method of revenue recognition, each air carrier periodically verifies its passenger revenue accounting practices. The purposes of this verification are to assess the degree of reliance that can be placed on the carrier's earned passenger revenue and, at the same time, to test the balance in the ATL account.

3.64 To perform ATL verification under the sampling method, some airlines open a new ATL account for unearned revenue on the first day of the month in which the verification begins (generally three months prior to the airline's fiscal year end). Only credit entries for tickets sold for the new period are recorded in this account. All lifted coupons, refunds, exchanges, and liabilities for OL and OAL coupons are segregated between those sold in the prior period and those sold in the new period. The applicable amounts are charged to the appropriate period's ATL account.

3.65 The carrier verifies the prior-period ending balance by analyzing lifted coupons, refunds, exchanges, and invoices for a period within the current period. The length of time of the analysis varies but should not exceed 12 months. All transactions with a validation date (sales date) prior to the first day of the new period are accumulated in this analysis. The value of the prior-period tickets and coupons used in the verification may be derived from the priced fare of each prior-period lifted coupon, or it may be an amount determined by sampling the coupons.

3.66 Under either process, adjustments to the recorded ATL balance are frequently necessary. Common adjustments to ATL result from revenue breakage, partially used tickets, invalid nonrefundable tickets, pricing errors, computer processing errors, and so forth. See the "Passenger Revenue Recognition Model" section of this chapter. After a reasonable period, an estimate is made of remaining unused tickets (those sold in the prior period that are still expected to be used but are unused as of the current period), and the airline can assess the accuracy of its estimates and make necessary adjustments to future estimates.

Unmatched Usage

3.67 A key control in either a sales/use match or sampling system is the investigation of what is referred to as *unmatched usage*. Unmatched usage occurs when a passenger uses a ticket and the airline has no record of the original ticket sale. Usage may be in the form of provided transportation, exchange, refund, or certain other form. With advances

in technology, the number of tickets used that the airline has not recorded as sold has become extremely low. When unmatched usage occurs, it typically results from the use of a ticket prior to the sale being recorded through the sales reporting process, specifically for travel agency and international sales. In these situations, the ticket usage is ultimately matched with the recorded ticket sale and revenue recognition occurs as of the date of travel. However, the investigation of unmatched usage can also identify sales that were incorrectly or never recorded by a travel agency or other sales agent and for which the airline still needs to collect the fare. The primary accounting issue associated with unmatched usage is valuation of coupons because the sale has not yet been recorded and, therefore, the actual amount for which the ticket was sold is not included in the revenue accounting system. In these circumstances, the revenue for passenger travel is generally recorded using the best information available to the airline. For tickets sold on a GDS, airlines frequently use TCN data provided by the GDS to recognize revenue on unmatched usage. If TCN data are not available, the airline may use other segment- or yield-based estimates to determine revenue for these tickets. Whichever method is used, an airline should track the accuracy of its pricing of unmatched usage and make corrections as appropriate to deal with any pricing issues identified.

ATL Breakage

3.68 ATL is the value of unused transportation sold by the air carrier and includes both the liability for transportation to be provided by the carrier selling the ticket and liability for transportation that may be provided by other air carriers. ATL also includes ATL breakage. Historically, *ATL breakage* has been defined as recorded ticket sales that remain partially or wholly unused after either the scheduled departure date or ticket expiration date. ATL breakage generally has included both the revenue breakage and invalid tickets, as defined in the “Ticket Validity” and “Revenue Breakage” sections.

3.69 Airlines have historically used a variety of methods to account for ATL breakage. One common method of accounting for ATL breakage includes recording an estimate of revenue breakage in the month of departure or the month of ticket expiration. As further

discussed in the following sections, the AICPA Accounting Standards Executive Committee (AcSEC) recommends that airlines recognize revenue breakage for valid tickets at the date of expiration—AcSEC believes that is the preferable accounting policy. However, AcSEC believes that if certain conditions (set forth in the "Passenger Revenue Recognition Model" section) are met, an airline may elect to recognize breakage before expiration at the date when all services have been provided. If an airline meets those conditions and chooses to recognize breakage before expiration, revenue breakage may be recognized on the departure date.

Ticket Validity

3.70 For purposes of this discussion, ticket validity refers to the status of the ticket prior to its contractual expiration date (assumed to be one year from the date of sale). All unused tickets are either valid or invalid as determined by the specific airline's ticketing policies. A *valid ticket* is a ticket that maintains its validity (that is, the ticket has value and the customer can travel with the ticket, exchange it for future travel, or obtain a refund) until its contractual expiration date. An *invalid ticket* generally loses its value at departure date or, in certain circumstances, at some point subsequent to departure date but prior to its contractual expiration date.

3.71 The following table provides examples of valid and invalid tickets. Each category of valid and invalid tickets is discussed in the following sections. It is assumed that the departure date has passed in all of the following examples.

Invalid Tickets	Valid Tickets
• Nonrefundable/nonexchangeable tickets • Nonrefundable tickets without continuing validity	• Refundable tickets • Nonrefundable tickets with continuing validity

- Tickets involving gaming, for example, nonrefundable partially used tickets that have no continuing value based on fare rules
- Travel vouchers issued for passenger inconvenience

Revenue Breakage

3.72 *Revenue breakage* is defined in this guide as the recognition of revenue before the airline has performed all its obligations under the sales arrangement because the customer has not required the airline to perform and is unlikely to do so. Revenue breakage consists of refundable and nonrefundable tickets that remain unused past departure date, have continuing validity (valid tickets), and are expected to ultimately expire unused as well as valid travel vouchers that are not expected to be redeemed prior to their expiration date.

3.73 The passenger revenue recognition model described in this chapter provides guidance on determining when to recognize revenue breakage for valid tickets and travel vouchers. AcSEC believes that invalid tickets are not revenue breakage and recommends that they be recognized as revenue at the point when they become invalid, which is usually the departure date.

3.74 *Nonrefundable Tickets.* For many airlines, the majority of tickets sold are nonrefundable restricted-fare tickets, which carry lower prices and frequently require charges for fare changes and, in some cases, change fees (up to $100) before the ticket itinerary can be changed. In the past, certain carriers allowed customers with nonrefundable tickets to cancel existing reservations after the departure date and exchange the value of the canceled ticket for a ticket on another flight. In recent years,

most carriers have modified their fare rules to eliminate customers' ability to exchange nonrefundable tickets if they fail to notify the carrier prior to the original departure date that travel will not occur. Regardless of the airline's ticket validation policy, revenue breakage (as defined herein) includes only those nonrefundable tickets for which the departure date has passed, that have continuing validity, and that are expected to ultimately expire unused.

3.75 For example, if a ticket is nonrefundable and requires notification in advance of the departure date in order to be exchangeable for future transportation, and if such notification was not made by the passenger, the ticket is invalid after the departure date. As such, revenue recognition at the departure date is appropriate because the airline has fully performed its obligation to the passenger. Such tickets are not considered revenue breakage but are recognized as revenue at departure date because the tickets become invalid at that point.

3.76 When estimating revenue breakage based on the passenger revenue recognition model described in this chapter, it is necessary to consider the effect of historical customer accommodations (for example, circumstances in which an invalid ticket or a formerly valid ticket past its expiration date is honored by the airline, generally for customer convenience reasons). AcSEC believes that, in order to recognize revenue from invalid tickets and revenue breakage prior to the ticket expiration date (as discussed in the "Passenger Revenue Recognition Model Passenger Revenue Recognition Model" section of this chapter), the airline would also have to demonstrate a history of not honoring invalid or expired tickets due to customer accommodations except in very limited circumstances.

3.77 *Refundable Tickets.* Revenue breakage includes only those refundable tickets for which the departure date has passed and that are not expected to be refunded or reissued for travel prior to their expiration date.

3.78 *Tickets Involving Gaming.* Gaming occurs in certain instances in which, due to airline pricing practices, it is more economical to purchase two round-trip tickets and use only one-half of each ticket, rather than purchasing one round-trip ticket for the intended dates of travel, or in instances in which a leg of a ticket is purchased with no intent to use the leg because the overall ticket has a lower cost than a ticket without the additional leg (referred to as *hidden cities*). Tickets that are unused and represent "throw-away," that contain hidden cities, or that involve other ticketing phenomena commonly referred to by airlines as *gaming* have no validity after the scheduled departure date because frequently the ticketing rules permit no refund or exchange of such tickets. Furthermore, the customer would not be entitled to any refund or exchange because the value of the ticket actually flown exceeds the value of the ticket purchased. As a result, AcSEC recommends that revenue related to such items be recognized as of departure date.

3.79 *Travel Vouchers.* Travel vouchers are generally issued in connection with denied boarding situations in which a passenger is involuntarily denied boarding and placed on another flight and provided with a voucher as an accommodation for the passenger's inconvenience. Travel vouchers are also provided as an enticement for passengers to accept a voluntary change in flights. In denied boarding situations, the travel voucher is issued in addition to providing another flight to the customer to complete his or her originally scheduled trip. Travel vouchers may also be issued to passengers as compensation related to other customer service issues. Travel vouchers are usually issued for either free travel (for example, a round trip anywhere in the United States but usually excluding Hawaii and Alaska) or for a fixed amount (frequently ranging from $100 to $500) that can be used by the passenger to pay for future travel purchases from the issuing airline. Generally, travel vouchers cannot be refunded and expire one year from the date of issuance. Partially used travel vouchers frequently have no continued validity for the unused value. Unused travel vouchers have continued validity generally until their expiration date.

3.80 Travel vouchers are recorded at the date of issuance, which is usually the departure date of the ticket for which the voucher was issued due to passenger inconvenience. Airlines record the initial issuance of travel vouches as either an expense or as a reduction of passenger revenue, depending on the carrier's policy; however, the total revenue recognized for the initial ticket and the voucher cannot exceed the cash collection from the passenger. AcSEC believes that characterization of travel vouchers as a reduction of passenger revenue is preferable. Then, when travel vouchers are generally exchanged for tickets, revenue for the exchanged tickets is recognized upon travel in accordance with standard revenue recognition procedures described previously. Airlines record travel vouchers for dollars off at their face value and travel vouchers for free trips at their fair value. Fair value of travel vouchers for free trips is generally estimated based on similar tickets with comparable restrictions. Airlines also record breakage related to travel vouchers in accordance with their established policy.

Passenger Revenue Recognition Model

3.81 The following is an illustration of the application of the passenger revenue recognition model in the airline industry. It is based on guidance provided in the previous sections of this chapter and serves as a guide to the detailed discussion that follows. It is illustrative only and has been prepared to show how certain fact patterns might affect passenger revenue recognition. Revenue recognition decisions reached in this illustration are based on the assumptions listed in the next paragraph. Facts and circumstances of each individual airline should be considered in the application of this model.

3.82 The assumptions are as follows:

- All ticket sales and travel vouchers are recorded in ATL.
- Tickets and travel vouchers are valid for one year from date of issuance.

- Nonrefundable tickets (unused) become invalid on the scheduled travel date unless the customer complies with the airline's ticketing rules (no value after travel date).
- Nonrefundable tickets (unused) remain valid after the scheduled travel date if the customer complies with the airline's ticketing rules. Thereafter, 20 percent are never used prior to expiration (revenue breakage).
- Nonrefundable tickets (partially used) become invalid on the scheduled travel date.
- Refundable tickets (including partially used) can be refunded within one year.
- Refundable tickets (including partially used) can be exchanged within one year. No change fee is charged, but the airline either collects or refunds any difference in airfare.
- 10 percent of valid refundable tickets (including partially used) are never submitted for refund or exchange prior to expiration (revenue breakage).

3.83 Revenue recognition occurs as outlined in the following table.

Ticket Usage	**When the Revenue is Recognized**
Passengers using tickets	At actual travel date
Tickets that become invalid, generally on departure date, for which the customer does not comply with the airline's ticketing rules	At scheduled departure date
Revenue breakage for tickets	On the expiration date or, under certain conditions, on the scheduled departure date (see paragraphs 3.84–.87 of this chapter)
Revenue breakage for travel vouchers	On the expiration date or, under certain conditions, at the date of issuance because this is generally the departure date of the original ticket for which the voucher was issued due to passenger inconvenience

3.84 AcSEC recommends that airlines recognize revenue breakage for valid tickets at the date of expiration. AcSEC believes that is the preferable accounting policy. However, AcSEC believes that if the conditions set forth in paragraphs 3.86 and 3.87 are met, an

airline may elect to recognize breakage before expiration at the date when all services have been provided. If an airline meets those conditions and chooses to recognize breakage before expiration, revenue breakage may be recognized on the departure date.

3.85 AcSEC believes that departure date is an acceptable point at which to recognize revenue breakage, provided the conditions set forth in paragraphs 3.86 and 3.87 are met, because the probability of redemption and the customer requiring performance become remote at that point. Furthermore, some believe that when the originally scheduled departure date has occurred and the ticket remains unused, the airline has performed its obligation to provide transportation.

3.86 AcSEC believes that the SAB No. 104 criteria for recognizing refundable membership fees provide a sound model for conditions that need to be met in order for revenue breakage to be recognized before ticket expiration. Accordingly, AcSEC believes that the following conditions, if met, would provide a basis for supporting the recognition of breakage at the scheduled departure date:

- The estimates of breakage are being made for large pools of homogeneous items.
- Reliable estimates of breakage can be made on a timely basis.
- There is a sufficient company-specific historical basis upon which to estimate breakage, and the airline believes that such historical experience is predictive of future events.

3.87 AcSEC believes that, in accordance with the first condition, breakage items that could be expected to have similar breakage patterns would need to be aggregated into pools. Generally, refundable tickets, nonrefundable tickets, and travel vouchers would be considered separate homogeneous pools. Depending on the circumstances, some of these categories may need to be broken down further. AcSEC believes it is preferable that the accounting policy for breakage for each of these separate homogeneous pools be consistent. AcSEC observes that start-up airlines would generally be unable to meet the third condition in paragraph 3.86 and thus generally would not recognize breakage prior

to expiration. However, once an airline has sufficient history on which to base its estimates, it may choose to recognize breakage at departure date if the other two conditions in paragraph 3.86 are also met. In those circumstances, it would not be considered a change in accounting principle because the airline's accounting policy has not changed. In the example of a start-up airline, the airline's accounting policy from the beginning was to recognize revenue breakage prior to ticket expiration; however, the airline had to default to recognizing breakage at ticket expiration because it did not have sufficient history to estimate breakage. Once the airline accumulates sufficient company-specific historical basis upon which to estimate breakage, it would be able to begin recognizing breakage prior to ticket expiration.

3.88 An airline's breakage policy should be disclosed pursuant to Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*.

Change and Other Transaction Fees

3.89 Change fees are charges imposed on passengers for making schedule changes to nonrefundable tickets. Such fees are intended to compensate the airline for allowing and completing the ticket exchange, including covering the cost thereof. Change fees are not refundable, have no separate value to the customer once paid, and do not attach to the ticket. In other words, if the ticket is exchanged again, only the value of the ticket (face value), exclusive of the change fee, could be used against the value of the new ticket, and another change fee would likely apply. The timing and methodology of charging change fees vary among airlines. Some airlines assess the change fee by reducing the face value of the cancelled ticket by the amount of the change fee at the time the customer notifies the airline that the original flight will not be taken. Other airlines assess change fees if and when the ticket is ultimately exchanged, which may occur before or after the original flight. If the customer does not comply with the airline's ticketing rules, the original ticket may become invalid and would not be permitted to be changed. See the "Passenger Revenue Recognition Model" section of this chapter.

3.90 There are two approaches to account for change fees: first as a separate transaction independent from the original ticket sale and second as part of the original ticket sale. Under the first approach, which is the predominant industry practice, change fees are viewed as a separate transaction independent from the original ticket sale because the fees are charged subsequent to the initial sales transaction, there is no requirement on the passenger to pay the fees at the time of the original sale, and passengers who pay change fees receive additional utility that they are not otherwise entitled to (that of being allowed to exchange the original ticket and, therefore, preserve its value). Under this approach, revenue related to change fees is recognized when the fee is assessed, which might be when the original ticket is either cancelled or exchanged.

3.91 Under the second approach, it is believed that there is only one deliverable—passenger transportation—and that change fees do not represent a separate revenue-generating event because the actual transportation is so significant to the overall arrangement that performance cannot be deemed to have taken place until the airline provides transportation to the passenger. As such, revenue related to change fees is recognized when the ultimate transportation service is provided.

3.92 In January 2007, an issue titled “Accounting for Ticket-Change Fees in the Airline Industry” was brought to the EITF Agenda Committee. This issue was intended to address whether ticket change fees should be evaluated and accounted for as part of a multiple deliverable arrangement pursuant to EITF Issue No. 00-21 or whether the presumption in paragraph 2 of EITF Issue No. 00-21 can be overcome such that ticket change fees should not be evaluated in combination with the passenger's purchase of the airline ticket. This issue also would have dealt with the timing of revenue recognition if it was concluded that the airline ticket change fee was outside of the scope of EITF Issue No. 00-21. The EITF Agenda Committee decided not to add this issue to the EITF agenda.

3.93 Other transaction fees (for example, paper ticket fees, delivery fees, and reservation fees) are charged by airlines for providing various services. Airlines need to consider whether such fees are separate revenue-generating transactions under EITF Issue No. 00-21. Fees that qualify as separate units of accounting are generally recognized as revenue when the related service is provided and classified as other operating revenues. Fees that do not qualify as separate revenue-generating transactions should be deferred and recognized as revenue when the related transportation service is provided.

3.94 As a result of the difference in nature of change and other transaction fees, some airlines classify this revenue as *other operating revenue* and not as a component of passenger revenue. Although diversity in practice exists in the classification of change and other transaction fees, either presentation is believed to be appropriate as long as the airline discloses the classification of change and other transaction fees if such amounts are material.

Taxes and Fees

3.95 The primary fees collected on each ticket by airlines are summarized in the following table.

TAXES AND FEES ON PASSENGERS		
Type of Tax	**Percentage or Flat**	**Unit of Taxation**
Federal Ticket Tax (1)	Percentage	Domestic Airfare
Federal Flight Segment Tax (1)	Flat fee	Domestic Enplanement
Federal Security Surcharge (2)	Flat fee	Enplanement at U.S. Airport
Airport Passenger Facility Charge (PFC) (3)	Flat fee	Enplanement at Eligible U.S. Airport

International Departure Tax (1, 4)	Flat fee	International Passenger Departure
International Arrival Tax (1, 4)	Flat fee	International Passenger Arrival
Immigration and Naturalization Service (INS) User Fee (5)	Flat fee	International Passenger Arrival
Customs User Fee (6)	Flat fee	International Passenger Arrival
Animal and Plant Health Inspection Service (APHIS) Passenger Fee (7)	Flat fee	International Passenger Arrival
Frequent Flyer Tax (8)	Percentage or flat fee	Frequent Flyer Awards
TAXES AND FEES DIRECTLY ON THE AIRLINE		
Type of Tax	**Percentage or Flat**	**Unit of Taxation**
Frequent Flyer Tax (9)	Percentage	Sale of Frequent Flyer Miles
APHIS Aircraft Fee (7)	Flat fee	International Aircraft Arrival
Jet Fuel Tax (1)	Fee per gallon	Domestic Gallon
Leaking Underground Storage Tank (LUST) Fuel Tax (10)	Fee per gallon	Domestic Gallon
Air Carrier Infrastructure Security Fee (2)	Per carrier	Calendar Year 2000 Screening Costs

NOTES:

1. Deposited to the federal Airport and Airway Trust Fund, which funds the majority of the Federal Aviation Administration (FAA) annual budget.
2. Funds screeners, equipment, and other costs of the Transportation Security Administration.

3. PFCs are federally authorized but levied by local airport operators, which set the amounts (up to $4.50 per enplanement, to a maximum of two PFCs per one-way trip and four per journey).
4. Does not apply to those simply transiting the United States between two foreign points.
5. Funds inspections conducted by the U.S. INS.
6. Funds inspections conducted by the U.S. Customs Service. Passengers arriving from Canada, Mexico, U.S. territories and possessions, and adjacent islands are exempt.
7. Funds U.S. Department of Agriculture agricultural inspections, conducted by the U.S. Animal and Plant Health Inspection Service (APHIS). Arrivals from Canada are exempt.
8. A form of federal ticket tax imposed on passengers redeeming their frequent flyer awards.
9. A form of federal ticket tax, deposited with the federal Airport and Airway Trust Fund, imposed on proceeds from the sale of the right to award (frequent flyer) miles to third parties (for example, credit card issuers, car rental companies, restaurants, and hotels); took effect October 1, 1997.
10. Supports the LUST Trust Fund.

Taxes and Fees on Passengers

3.96 The taxes and fees assessed on the sale of tickets to end customers have traditionally been considered by airlines as taxes collected as an agent. Accordingly, all such taxes and fees have been presented on a net basis (that is, excluded from revenue and recorded directly as liabilities until paid to the respective taxing authority). EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)," applies to any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but are not limited to, sales, use, value added, and some excise taxes. Therefore, EITF Issue No. 06-3 is applicable to taxes and fees assessed on the sale of tickets to

passengers. EITF Issue No. 06-3 provides that the presentation of taxes within its scope on either a gross (included in revenue and costs) or a net (excluded from revenue) basis is an accounting policy decision that should be disclosed pursuant to APB Opinion No. 22. Therefore, an airline may choose to present those taxes on a gross basis. It has been the longstanding industry practice to present those taxes on a net basis because they are collected in the capacity of an agent. AcSEC believes that net presentation is preferable. EITF Issue No. 06-3 also sets forth disclosure requirements that are discussed in Chapter 7 of this guide.

Taxes and Fees Directly on the Airline

3.97 Taxes and fees assessed directly on the airline are considered taxes and included in operating expenses in the carrier's financial statements. Jet fuel taxes should be included as a component of fuel expense.

3.98 See Chapter 10 for a discussion of certain fees and illustrative reports issued in attest engagements in connection with those fees.

Frequent Flyer Programs

Introduction

3.99 FFPs were introduced by many airlines in the early 1980s, principally to induce higher levels of repeat business from their customers. The basic concept of an FFP is to encourage passenger loyalty by providing awards geared to the frequency of travel on the sponsoring airline, typically in the form of frequent flyer miles, points, or segments that can be accumulated and converted into free or discounted travel.

3.100 Some airlines also enter into code-sharing or other arrangements whereby they cooperate with other airlines in providing travel-related benefits to passengers. Typically, such arrangements involve an ability to access each other's FFP so that members of one

airline's FFP can use their points to obtain awards on another participating airline, earn credits for flights taken on another participating airline, or both.

3.101 Some FFPs also involve participants other than airlines, for example, travel-related businesses such as hotels or car rental companies. These businesses similarly reward FFP members for the purchase of their particular products or services by adding to the members' points or miles accumulated under the FFP.

3.102 Various kinds of awards may be offered by an FFP in exchange for frequent flyer miles or points accumulated under the program, including:

- The right to buy a ticket at a discount
- The right to an upgrade
- The right to a free companion ticket
- The right to free travel on the sponsoring airline or on a participating airline
- The right to other nontravel awards

3.103 The extent of the marketing benefits to be obtained by the sponsoring airline from an FFP depends partly on the airline’s ability to handle the extra traffic generated by the FFP while not displacing fare-paying passengers. As a result, as FFPs have developed, it has become more commonplace for airlines to impose restrictions involving, for example, the limitation of capacity that is available for frequent flyer passengers on some or all flights, including in particular those during peak travel periods on high density routes.

Methods of Accounting for FFPs

3.104 There are two methods of accounting for free or discounted travel arising under FFPs: the incremental cost method and the deferred revenue method. There is no specific authoritative accounting guidance on the accounting for FFPs. Standards setters, such as the FASB, AcSEC, and the EITF, previously considered but reached no consensus on reporting FFPs. Although certain aspects of frequent flyer accounting have been governed by the principles set forth in SAB No. 104 (primarily deferred revenue on

multiple units of accounting), other aspects have simply evolved as a matter of industry practice. In the late 1980s, AcSEC began a project to address FFP accounting. AcSEC abandoned the project, however, in September of 1990. Over the years, airlines have used both methods and provided certain disclosures concerning FFPs. The EITF also attempted to address this issue. However, EITF Issue No. 00-21 specifically excluded FFPs from its scope because FFPs were intended to be addressed in EITF Issue No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers and Offers for Free Products or Services to be Delivered in the Future," which was subsequently removed from the EITF's agenda in light of the FASB's revenue recognition/liability extinguishment project. Practitioners should be alert to developments in connection with that project because these developments could affect accounting for FFPs.

3.105 Under the incremental cost method, a liability is recorded for the incremental cost associated with rewarding those FFP members expected to redeem frequent flyer miles, points, or segments. For awards expected to be redeemed for free travel on the sponsoring airline, incremental cost typically includes the costs of food, drink, fuel, ticket delivery, and certain types of insurance because these are the typical incremental costs the airline will incur to provide travel to one additional passenger. For awards that may be redeemed on other airlines, the incremental cost is the amount the sponsoring airline will be obligated to pay the other airline (see the "Accounting for Interline FFP Miles" section of this chapter for additional guidance). The calculation depends on assumptions about the number of miles, points, or segments expected to be issued, redeemed, expired, or purged and the mix of awards to be redeemed.

3.106 Under the deferred revenue method, a portion of passenger revenue generated from the sale of tickets relating to the future frequent flyer benefit is deferred until such time as a ticket associated with the use of the frequent flyer award is used. The calculation of the amount of deferred revenue depends on assumptions about the number of miles, points, or segments to be redeemed; the mix of awards to be redeemed; and the yield assigned to the mileage or points attributed to the expected redemption of free

travel awards. Airlines frequently derive the yield allocated to the FFP travel award from a ticket on the same route with similar restrictions. However, the revenue allocated to the future frequent flyer benefit can be determined based on transactions involving the transportation element of sales of miles to third parties (such as airlines), if representative of vendor-specific objective evidence of fair value as discussed in EITF Issue No. 00-21.

3.107 The deferred revenue method is acceptable in all circumstances, while the incremental cost method is acceptable in only certain circumstances. For example, the incremental cost method is inappropriate in circumstances in which (*a*) a significant number of paying passengers are displaced by passengers redeeming awards[4] or (*b*) the value of an individual award is significant compared with the purchase earning the award.

3.108 Historically, there has been substantial industry practice to use the incremental cost method rather than the deferred revenue method. The incremental cost method is based on the concept that FFP awards are tightly controlled so that passengers redeeming the awards are simply filling excess capacity and, as a result, the carrier is incurring only the incremental cost of providing what would have otherwise been an empty seat. However, if FFP awards are without limitations (such as blackout dates) or if special promotional programs are used, AcSEC recommends that airlines evaluate the appropriateness of the incremental cost method for such programs.

3.109 Under both methods, a key factor in estimating an FFP obligation is the estimate of frequent flyer miles, points, or segments that are expected to be redeemed. In practice, that estimate is influenced by a number of factors, including:

- The threshold of miles, points, or segments required before an FFP member can

4 For purposes of applying the guidance in this guide, the fact that a passenger redeeming an award might otherwise have been a paying passenger had they not redeemed the award should not lead to the conclusion that a paying passenger has been displaced by a passenger redeeming an award. In other words, passengers redeeming an award do not displace themselves as paying passengers for purposes of applying the guidance in this guide.

secure an award and the mix of awards under the FFP. The rate of redemption will clearly be affected by the ease with which members can accumulate sufficient miles, points, or segments to make a redemption and the attraction of the awards offered by the FFP.

- The expiration/purge period, if any, established for the program. Some FFPs provide that frequent flyer miles or points must be used within a specified period or they are lost. The rate of redemption of the air miles population will be affected by any systematic culling of unused miles, points, or segments.

- The airline's redemption experience. Airlines develop statistics including:
  - Overall numbers of frequent flyer miles or points redeemed
  - The proportion taken in air travel (including air travel provided by airline partners) and nonair travel awards
  - Flight segments against which awards are taken
  - Nature of other awards taken
  - The frequency of redemptions
  - The utilization of air miles among particular member categories

3.110 Some airlines with well established programs and comprehensive redemption data have been able to build up experience-based algorithms for estimating the likelihood and type of redemptions.

3.111 The cost to the FFP of offering nonair travel awards is the cost charged to the airline for the product. Airlines need to accumulate sufficient data regarding the proportion of FFP points redeemed against nonair travel awards to be able to properly estimate their obligation for nonair travel awards.

Accounting for FFP Miles Sold to Third Parties

3.112 A number of airlines have sought to extend the coverage of their FFPs by involving in their programs both airline partners (for example, a U.S. airline may have another domestic airline or a foreign airline partner that participates in its FFP) and nonairline participants (for example, credit card issuers, car rental companies, restaurants, and hotels). The most prevalent nonairline participants are credit card issuers. Nonairline participants grant frequent flyer miles or points as an inducement for the purchase of their products or services and pay the airline (or effectively the FFP) for the ability to utilize the marketing benefits of the FFP. Affinity programs of nonairline participants account for a significant portion of the miles issued in an FFP.

3.113 AcSEC believes that EITF Issue No. 00-21 provides the most appropriate guidance for recording the sale of frequent flyer points to nonairline participants. Under EITF Issue No. 00-21, the airline would, if possible, separate the component of the sale representing the value of the future travel awards (the travel component) from the component that represents the amount associated with other goods or services acquired by the nonairline participant, such as the right to use the airline's database or customer mailing list (the marketing component). If objective and reliable evidence of fair value of the delivered items (the marketing component) is not available, the residual method is used in accordance with paragraph 12 of EITF Issue No. 00-21. The fair value of the component representing travel can be determined based on transactions involving the transportation element of sales of miles to third parties (such as other airlines) or an equivalent restricted fare, which is used as a proxy for the value of travel on a frequent flyer award. The marketing component may be recognized as revenue at the point of sale of the frequent flyer miles to the frequent flyer affinity partner, while the travel component is recognized as travel occurs. Because airlines do not track miles on a specific identification basis (that is, miles awarded for flying are not distinguished from those sold to nonairline participants), airlines accounting for their FFPs using the incremental cost method have developed a convention for allocating miles used for awards between miles sold to nonairline participants (a deferred revenue model) and their FFP (an incremental cost model). This convention assumes that the miles sold to nonairline participants are used for travel awards on a straight-line basis over the

historical usage period of the frequent flyer mileage with the balance of miles used for awards being attributed to their FFP. AcSEC recommends that revenue attributed to the marketing component be classified as other operating revenue and that revenue attributed to the travel component be classified as passenger revenue.

3.114 The accounting previously discussed for revenue associated with the sale of frequent flyer miles or points to third parties was adopted by airlines upon the issuance of SAB No. 101, *Revenue Recognition in Financial Statements*, which was later replaced by SAB No. 104.

Accounting for Interline FFP Miles

3.115 Airlines frequently include other airline partners in their FFPs to extend their programs in order to attract and retain certain premium passengers as well as to offer their FFP members extended options for the potential use of their accumulated miles, points, or segments. In most of these cases, the airline also participates in the other airline's FFP on a reciprocal basis. Such cross-participation by airline partners in each other's FFP creates a number of accounting issues that stem primarily from the settlement of usage under the contracts between the carriers. The majority of contracts call for settlement of the net activity between the two carriers' FFPs—generally, at least annually—at a stated rate per mile, point, or segment that is frequently higher than the carriers' own incremental cost to provide an FFP seat. In fact, these rates are frequently up to 10 times higher than the incremental cost rate used by the participating airlines because they tend to represent the miles, points, or segments equivalent of the fair value of a restricted ticket.

3.116 In the early stages of these partner relationships, many airlines accounted for interline FFP activity on a net basis. Individual activities were not recorded; rather, the net result of the settlement was recorded as income or expense in the period of settlement. AcSEC believes that gross-basis accounting is the appropriate practice.

3.117 Following is an illustration of the accounting for interline FFP miles. In this illustration, four kinds of activities affect the settlement between Home Airline (HA), the reporting entity, and Partner Airline (PA).

1. Home Airline FFP members earn miles in the Home Airline FFP for travel that occurred on Partner Airline. Partner Airline is obligated to pay Home Airline for the miles earned.

2. Home Airline FFP members use miles to fly on Partner Airline. Home Airline is obligated to pay Partner Airline for the seats provided to Home Airline FFP members by Partner Airline, generally at a converted award level.

3. Partner Airline members earn miles in the Partner Airline FFP for flights on Home Airline. Home Airline is obligated to pay Partner Airline for the miles earned.

4. Partner Airline FFP members use their miles to fly on Home Airline. Partner Airline is obligated to pay Home Airline for the seats provided to the Partner Airline FFP members by Home Airline. The seat cost from Home Airline is generally at a converted award level.

3.118 The following table summarizes the accumulation of the net settlement of the program and the accounting for the previously described activities on a gross basis.

Activity no.	Activity	Effect on Settlement	Miles	Assumed Settlement Rate per Mile (cents per mile)	Net (Payment) Receipt by HA	Treatment Under Gross-Basis Accounting by HA
1.	HA earn on PA	PA pay HA	240,000,000	0.01	$ 2,400,000	Deferred revenue
2.	HA burn on PA	HA pay PA	440,000,000	0.01	(4,400,000)	Frequent flyer liability
3.	PA earn on HA	HA pay PA	172,000,000	0.01	(1,720,000)	Operating expense

4.	PA burn on HA	PA pay HA	772,000,000	0.01	7,720,000	Current revenue
	Amount due from PA				$ 4,000,000	

Activity 1. The payment received from Partner Airline is treated as deferred revenue and is recognized as travel occurs as discussed in the "Accounting for FFP Miles Sold to Third Parties" section of this chapter. The accounting for this activity is consistent with the accounting for all other mileage sales to third parties. Assuming that Home Airline's historical usage period is 3 years, $2,400,000 of deferred revenue would be amortized over 3 years, which would result in recognition of $800,000 of revenue in Year 1 in addition to $7,720,000 of revenue resulting from Activity 4.

Activity 2. The payment to Partner Airline represents a settlement of the existing Home Airline FFP liability and is offset against it. This transaction would have no effect on Home Airline revenue/expense. See the "Effect on Valuation of FFP Liability" section of this chapter for further discussion.

Activity 3. The payment is recorded by Home Airline as an operating expense to reflect the cost to purchase these miles from the Partner Airline FFP.

Activity 4. This represents passenger revenue to Home Airline.

3.119 *Classification of Components.* AcSEC recommends that Activities 1 and 4 be included in passenger revenue (with respect to Activity 1, upon amortization of the deferred revenue), that Activity 2 be offset against the frequent flyer liability, and that Activity 3 be recorded as an operating expense.

3.120 *Effect on Valuation of FFP Liability.* In this illustration, Activity 2 results in the settlement of a portion of Home Airline's existing FFP liability by paying another carrier

to provide transportation to one of its FFP members. Frequently, the contracts between partner airlines call for settlement rates that are substantially higher than the incremental cost that would be incurred by the sponsoring airline. AcSEC believes that if a carrier that uses the incremental cost method expects to settle a portion of its FFP awards with travel on other airlines at rates that are substantially higher than the incremental cost it would incur to provide that travel itself, that fact would need to be considered in estimating the airline's FFP liability. In substance, this is similar to valuing the liability for the cost of nonair travel awards that will be purchased by the airline to satisfy a portion of its FFP awards.

3.121 Airlines evaluate the effect of the anticipated settlement of their FFP liability on other airline partners in different ways. The most prevalent approach is to use the airline's recent history to estimate a historical pattern of FFP liability settlements by travel on partner airlines, to use that historical pattern to estimate the portion of outstanding FFP awards that will be settled with travel on partner airlines, and to value that portion of the liability based on the settlement rates contracted with its airline partners. AcSEC recommends that when an airline enters into a contract with a new partner, it accrue the additional liability based on the airline's best estimate of the portion of its FFP awards that will be settled on the new partner airline. Factors to consider in making that estimate include the contractual terms of the agreement with the new partner airline, the practical limitations on the number of frequent flyers who can reasonably redeem free travel awards on the new partner airline, the airline's expectations and forecasts developed for use in negotiating the agreement, and the potential impact on awards redemptions on other partner airlines as a result of the new agreement. AcSEC believes it would be inappropriate to not accrue a liability upon entering into a contract with a new partner due to a lack of historical experience with that particular airline.

Changes in Estimates Related to FFPs

3.122 The accounting for the various aspects of an airline's FFP is complicated and involves a large number of estimates and assumptions. Some of the more significant

assumptions include the type and value of the incremental costs components, estimates of how frequent flyer obligations will be settled (for example, by providing service or paying to a third-party airline to settle the obligation), the fair value of the undelivered element in the sale of a mile, and the period over which sold miles will be used by members when not tracked on a specific identification basis. Given the nature and significance of many of these estimates and assumptions, it is common to have changes in assumptions and estimates that affect the recorded amounts of the obligations or deferred revenues. Also, the appropriateness of these estimates needs to be reassessed on a regular basis. The frequency of this reassessment will depend on the sensitivity of the estimate to change. Changes in estimates should be accounted for in accordance with the provisions of FASB Statement No. 154, *Accounting Changes and Error Corrections*, which provides the following general guidance:

> *A change in accounting estimate shall be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.*

3.123 Changes in FFP-related estimates that affect the calculation of the FFP liability generally affect the period in which the change occurs, while changes in estimates related to revenue recognition on the sale of miles and related deferred revenue components generally affect both the period in which the change occurs and future periods and should be accounted for prospectively as a component of the amount and timing of revenue recognition on the sale of miles. The following table provides some examples of common changes in estimate in frequent flyer accounting and how each could be evaluated under the accounting provisions of FASB Statement No. 154.

FFP Common Changes in Estimate	Period of Accounting Recognition
• Changes to estimates of	• Current period charge or credit

incremental cost	to operations to reflect the updated estimate of the obligation or liability
• Changes to the settlement rate or portion of miles to be used on other airline partners	• Current period charge or credit to operations to reflect the updated estimate of the obligation or liability
• Changes in the fair value of the deferred component of the sale of miles	• Applied prospectively to determine future mileage sales transactions with respect to the initial recognition
• Changes in the period over which miles sold are expected to be used by program members to claim travel	• Applied prospectively to future mileage sales transactions and any unamortized deferred revenue balances

Prepurchase of Miles

3.124 As part of their scheduled airline service, most airlines operate a loyalty program featuring airline mileage and other travel credit or awards issued under co-branded credit card programs. Recently, airlines have looked to these co-branded credit card programs as an additional source of financing. To protect the credit card issuers in the event an airline goes into bankruptcy, the underlying financing arrangement can be structured as a prepurchase of miles by the credit card issuer to be used for fulfillment of awards offered to cardholders. Payment received by the airline from the credit card issuer is generally recorded as debt. When the credit card issuer grants miles to its customers, this debt is reclassified as deferred revenue. Under the terms of these arrangements, the airline may

be obligated to repurchase the prepurchased miles not used by the credit card issuer over some specified period. Prepurchased miles are generally recorded as additional indebtedness by the airline in accordance with guidance provided in EITF Issue No. 88-18, "Sales of Future Revenues."

Disclosures

3.125 See Chapter 7 for disclosure considerations related to FFPs.

Capacity Purchase Agreements—Gross Versus Net Presentation

Background

3.126 Regional jet contracts between a mainline airline and a regional airline are typically structured as capacity purchase agreements. Under these contracts, the mainline carrier "purchases" the use of the regional airline's aircraft and flight crews and other related services. The aircraft is painted in the colors and logos of the mainline airline. The mainline airline also takes responsibility for aircraft scheduling, ticket pricing, reservations, collections, and marketing. There are a number of variations of capacity purchase agreements, including cost-plus formulas, fee-per-departure formulas, capacity-based formulas, and block-hour-based formulas, to name a few. Ultimately, these formulas achieve a similar outcome, which is to cover the regional's costs and provide a margin. Mainline carriers use capacity purchase agreements because these arrangements allow them to expand their operations at lower fixed costs by using the regional's lower cost structure for operating jet aircraft. The mainline airline can also benefit from capacity purchase agreements because they enable the airline to better control its entire network of flights and serve strategic routes that might otherwise be uneconomical. See Chapter 9 for a more detailed discussion of capacity purchase agreements.

Presentation

3.127 To determine whether revenue from capacity purchase agreements should be reported on a gross basis (passenger or other transportation revenue reflects the ticket revenue, while the capacity purchase payments are reflected as operating expenses) or on a net basis (capacity purchase payments to the regionals are charged to passenger revenue), mainline carriers should first analyze the capacity purchase agreement under EITF Issue 01-8, "Determining Whether an Arrangement Contains a Lease." Revenue from capacity purchase agreements that contain a lease under EITF Issue No. 01-8 should be presented on a gross basis while agreements that do not contain a lease should be further analyzed under EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent," to determine whether gross or net presentation is appropriate.

Inherent Risks

3.128 In assessing audit risk, the auditor should consider those factors influencing inherent risk related to revenue recognition, advance ticket sales, receivables, and interline payables. Such factors include the following:

- The volume of sale and transportation transactions is immense, requiring sophisticated information technology systems.
- Certain airlines have very complex ticket pricing structures that result in numerous price changes, which can affect key revenue accounting estimates.
- The interline process requires significant estimation and can take up to 24 months for certain situations to resolve fully.
- Tickets are sold in foreign currencies, requiring translation of sale data to the airline's reporting currency and the repatriation of foreign currency cash amounts.
- Processing of lifted coupons has been outsourced by many airlines.
- Not all sales and use documents result in matching, necessitating a level of estimation in recording revenues.
- The interline settlement process results in net accounting for certain revenues and expenses.

- Not all lifted coupons are matched to sales information, resulting in unmatched usage and revenue breakage.
- There is a high degree of manual involvement in accruals, refunds, and the interline process.
- The frequent flyer arrangements between airline partners can be very complex.

Proposed AICPA Audit and Accounting Guide

Airlines

Chapter 4

Acquiring and Maintaining Property and Equipment

Background

4.01 The airline industry is capital intensive, with a significant portion of an airline's assets invested in property and equipment. An airline's property and equipment consist of three primary categories: flight equipment, ground property and equipment, and equipment under capital leases. The total cost recorded by an airline for purchased property and equipment includes all expenditures applicable to its acquisition. These include the manufacturer's sales price, sales or use tax, duty, freight costs, and the cost of any additions or modifications that qualify for capitalization. In addition, interest cost (such as the interest cost attributable to progress payments on aircraft purchase contracts and many construction projects) should be capitalized as part of the cost of the asset and disclosed in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Cost.*

4.02 Flight equipment generally consists of aircraft, rotable parts, and leasehold improvements. Work-in-progress accounts used to accumulate costs to be capitalized are also classified as part of flight equipment. An aircraft's airframe and engines usually are accounted for as separate assets, primarily due to the interchangeability of engines among airframes. Airlines generally classify flight equipment as either operating or nonoperating. Operating flight equipment includes all items in use in air transportation services or in services related to air transportation. Aircraft undergoing overhaul, modification, or repair or held for standby use as a spare (ready for immediate use as backup) remain in the operating accounts. Additionally, airlines typically include progress payments on flight equipment purchase contracts made to aircraft manufacturers

as part of property and equipment. As part of the aircraft purchase agreement, airlines frequently provide some of the interior to the manufacturer for use in the assembly process, referred to as buyer-furnished equipment (BFE). BFE typically includes seats, galleys, overhead bins, in-flight entertainment systems, and other equipment that the airline uses to provide customer service. This equipment may be accounted for separately due to airlines' tendency to replace these assets during the life of the aircraft.

4.03 Ground property and equipment generally consist of land, buildings, leasehold improvements (such as those made to passenger and cargo terminals), and equipment (including equipment used to service aircraft and traffic loads on airport ramps and in terminals; to maintain flight and ground properties; and to conduct sales, training, and other office functions).

4.04 Airlines account for ground property and equipment in a manner similar to other industries. Therefore, this chapter focuses primarily on the accounting for flight equipment, which, due to its unique nature, poses certain accounting issues that are not encountered in other industries. This chapter also includes a discussion of leases and other financing structures historically used by the airline industry to finance aircraft, airport facilities, and other assets because these structures often have unique accounting issues. Finally, because airlines operate in a heavily regulated environment, especially with respect to maintenance of their aircraft and related flight assets, this chapter touches on accounting issues and policies related to maintaining owned and leased aircraft, an area in which historically there has been significant diversity in practice.

Fleet Strategy

4.05 Aircraft fleet and capacity growth are significant, ever-changing fundamentals for airlines. An airline's fleet plan must consider a number of factors including the number of fleet types an airline has and the age and mission of the aircraft.

4.06 The number of aircraft types in a fleet is an important decision that can affect many aspects of an airline's operating expenses. For example, an airline with a limited number of aircraft types can reduce maintenance costs because mechanics need to be knowledgeable on fewer aircraft and spare parts requirements are reduced. Labor expenses can also be reduced because training costs are lower, and both crew and aircraft scheduling tend to be more efficient. From a capital expenditures standpoint, an airline may benefit from larger volume discounts from a supplier if it is ordering large quantities of only one aircraft type.

4.07 The age of the aircraft is important from an operating efficiency perspective because a younger fleet tends to be more fuel-efficient and to require less maintenance than an older fleet. Fuel efficiency is important because fuel is one of the largest operating costs of an airline. Depending on their maintenance accounting policy (for example, expense-as-incurred, deferral, or built-in overhaul, as discussed in the "Expense Recognition" section of this chapter), airlines with a young fleet may have a built-in "maintenance holiday," whereby their overall maintenance costs start low, particularly during the periods prior to the initial scheduled maintenance of the fleet, and then increase as the fleet ages, the warranties provided by the aircraft manufacturers expire, and scheduled maintenance activities commence.

4.08 The size of the aircraft serving a particular market is equally important because airlines attempt to match supply with demand. An aircraft that is too large for the market it serves would lead to empty seats, which decreases revenue per available seat mile (an important measure of the revenue productivity of an airline). Typically, airlines use large, wide-body aircraft for international markets with fewer frequencies and smaller, narrow-body aircraft and regional jets in domestic markets.

Owned Property and Equipment

Aircraft Modifications

4.09 Historically, airlines have undertaken major programs to modify interior configurations of aircraft—including the reconfiguration and replacement of customer service-related assets such as seats, galley equipment, in-flight entertainment systems, and storage bin space—typically in response to market forces and passenger demands. AICPA Statement of Position (SOP) 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications* (AICPA, *Technical Practice Aids,* ACC sec. 10,430), provides guidance on the treatment of such aircraft modification programs. According to SOP 88-1, if the modifications enhance the usefulness of the aircraft, the costs associated with the changes should be capitalized and depreciated over the estimated remaining useful life of the aircraft or the modifications, whichever is less. SOP 88-1 further provides that the cost of the replaced asset net of accumulated depreciation and anticipated recovery value should be charged to income in the current period. However, detailed records may often be inadequate to permit identification of the cost of the replaced asset; therefore, estimates may be required.

4.10 An aircraft consists of multiple components that may be replaced independently as part of a modification before the aircraft reaches the end of its useful life. For the replacement to be capitalized, the net carrying amount of the replaced part should be charged to expense in the current period. Additionally, an airline should consider whether depreciation should be accelerated if a part will be replaced in a future period.[5] Although replacement of an aircraft component often denotes an identical part, this term is interpreted more broadly. Replacement of a component occurs if a part is functionally replaced by another component, regardless of whether the replacement component is identical to the replaced component. A replacement component could, for example, be a

5 Airlines should periodically evaluate their experience with replacements. If an airline has a history of replacing certain parts before the parts are fully depreciated, it should consider assigning shorter useful

higher quality component that performs the same function as the replaced component, or an equal-quality, lower-cost component performing the same function. Additionally, one component consolidating two functions could replace two components, or two components highly specialized in function could replace a single component. The costs of modifications that do not qualify for capitalization should be expensed as incurred. Also, for modifications performed after an aircraft has been placed into service, the cost of any maintenance performed concurrently with a modification should not be capitalized as part of the modification but rather should be separated and accounted for in accordance with the airline's maintenance accounting policy.

4.11 Airlines modify their fleets continuously. At times, these modifications result in new functionality. For example, an airline could decide to add Internet access voluntarily or be mandated to add ground-to-air missile guidance tracking systems by the Federal Aviation Administration (FAA). These kinds of modifications are accomplished over time (during overnight or scheduled maintenance to avoid taking the aircraft out of revenue service) and ultimately result in the retrofit of the existing fleet. Eventually, the specifications are revised for new aircraft deliveries so that the aircraft will be delivered with the new functionality. The AICPA Accounting Standards Executive Committee (AcSEC) believes that such modifications meet the criteria for capitalization.

4.12 Airlines also receive Airworthiness Directives (ADs) from the FAA or similar mandatory equipment changes from regulators in other countries in which they operate. ADs require the airline to perform modifications or additional inspections and checks or install additional equipment on existing aircraft. Costs associated with ADs should be either capitalized as flight equipment or accounted for as maintenance based upon whether the expenditure qualifies for capitalization. Generally, the costs of ADs that add functionality or parts that were not on the original aircraft are capitalized in practice. Examples include collision avoidance systems and pilot door improvements. However, the existence of an AD requiring an airline to perform a particular modification does not

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lives to those parts.

result in automatic capitalization of such costs, absent the evaluation of the AD under guidance provided in this section.

4.13 The cost of painting of aircraft subsequent to placement of the aircraft into service should be charged to expense when incurred.

Manufacturer Incentives

4.14 Airlines frequently negotiate purchase and other incentives with flight equipment manufacturers whereby, as an inducement to purchase a particular manufacturer's aircraft, engine, parts, or other flight equipment, the manufacturer will grant credits or other incentives to the airline. These incentives can take many forms and may include credits for products such as additional aircraft, spare parts, or other equipment or for services such as flight crew training, maintenance, advertising, promotions, and aircraft financing.

4.15 The price of the aircraft should be allocated to the aircraft and purchase incentives on a relative fair value basis at the time of delivery of the aircraft or other underlying purchase or when the services or other incentives are delivered, whichever is earlier. Frequently, incentives are items that are sold separately by the manufacturer, such as spare parts, training, aircraft simulators, and other equipment. Although some incentives may not have established prices (for example, favorable financing or other services), their fair value can generally be determined by using available market information. The fair value of the incentive is recognized separately and accounted for based on its nature with an offsetting reduction to the cost of the aircraft or other underlying purchase. For example, if the aircraft manufacturer provides crew training to the airline, the fair value of the training is recognized as an asset, with an offsetting reduction in the purchase price of the aircraft. The asset is then charged to expense as the training is provided. Accounting for incentives in this manner properly reflects their usage, which is

independent of the usage of the aircraft or other underlying purchase following its delivery.

4.16 If the underlying contract is for multiple aircraft or engines, the incentives may be issued disproportionately to the aircraft or engines covered by the contract. Regardless of when the credits are issued, the total credits to be received should be allocated proportionately to the contractually committed aircraft or engine deliveries.

4.17 "Purchase" incentives received for aircraft or equipment in leasing arrangements should be accounted for similarly. For incentives received on aircraft under operating leases, a deferred credit should be recognized and amortized over the lease term as a reduction of aircraft rent expense or included in any gain or loss, evaluated under FASB Statement No. 13, *Accounting for Leases*, on the sale and leaseback of aircraft.

4.18 Sometimes manufacturers provide credits that increase based upon the number of aircraft ordered and that can apply to aircraft already delivered. FASB Emerging Issues Task Force (EITF) Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*, provides accounting guidance for those situations. These increased credits should be recognized as a reduction to the cost of the aircraft or other underlying purchase as the aircraft are delivered, provided the amounts are probable and reasonably estimable. If the credits are not probable and reasonably estimable, they should be recognized as the milestones are achieved. EITF Issue No. 02-16 indicates that the following factors may impair the ability to determine whether credits are probable and reasonably estimable:

- The credit relates to purchases that will occur over a relatively long period.
- There is an absence of historical experience with similar credits or the inability to apply such experience because of changing circumstances.
- Significant adjustments to expected credits have been necessary in the past.

- The asset to which the credit applies is susceptible to significant external factors (for example, technological obsolescence or changes in demand).

4.19 Subsequent changes in the estimated credits to be achieved are changes in estimate that should be recognized using a cumulative catch-up adjustment. That is, the airline would adjust the cumulative balance of the credit recognized to the revised cumulative estimate immediately and adjust depreciation, amortization, or rent expense accordingly in the current period.

4.20 For marketing purposes, when a new aircraft or engine model is developed, the manufacturers may have to induce their launch customer by granting more purchase incentives than would otherwise be granted for a well established model. It is important for the manufacturers to have an established customer base for the product in order to market it to others. These incentives can take the form of traditional credits, or they can contain more sophisticated features such as being contingent upon how many units of the model the manufacturer sells to others. The accounting for these and other incentives should reflect their purpose, which most likely is to reduce the cost of the related aircraft.

4.21 Manufacturers also will periodically issue credits for purposes other than the original acquisition of an aircraft or fleet. In evaluating the accounting for these additional credits, only credits issued by manufacturers directly as a result of the failure of aircraft or equipment to meet guaranteed performance thresholds or warranties may, in some circumstances, be recognized directly in results of operations as a reduction of the expense the guarantee or warranty relates to. The general premise is that credits issued to an airline as compensation for a short term performance issue that is subsequently corrected are recognized as a reduction to expense, while credits issued for longer term performance issues are accounted for as a reduction in the cost basis of the aircraft because the airline has, in effect, paid less for a lower performing asset. For credits that are issued at a time other than upon the initial acquisition of the aircraft and are accounted for as a reduction in the cost basis of the aircraft, an airline can either adjust

depreciation, amortization, or rent expense solely on a prospective basis or record a cumulative catch-up adjustment to the appropriate expense caption computed as though the asset had been initially recorded at the reduced cost basis, based on the policy elected by the airline that should be applied consistently.

Liquidated Damages

4.22 Liquidated damages (frequently referred to as late delivery fees) are contractual payments made to an airline by an aircraft or equipment manufacturer due to the nondelivery of an aircraft or equipment by a stated delivery date. The amount is generally specified in the asset purchase agreement and is negotiated to represent compensation for an airline's lost revenue associated with the delay in the delivery of an aircraft or equipment. Generally, liquidated damages are received prior to the delivery of the aircraft and have historically been accounted for as revenue. AcSEC believes liquidated damages should be accounted for in accordance with the guidance set forth in Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 2210.28, "Accounting for Certain Liquidated Damages" (AICPA, *Technical Practice Aids*), under which liquidated damages are typically recorded as a reduction of the cost of the asset and, therefore, reduce depreciation on a prospective basis, and EITF Issue No. 02-16. Amounts of liquidated damages in excess of the total cost of the asset would be recognized by the airline as income.

Advanced Delivery Deposits and Capitalized Interest

4.23 Aircraft manufacturers usually require progress payments to be made several months and even years prior to the delivery of ordered aircraft. Traditional aircraft purchase contracts require a minimal initial deposit at signing of the contract for each firmly committed aircraft ordered and then payments at various intervals prior to the scheduled delivery date of the aircraft (for example, 24, 18, and 6 months prior to scheduled delivery). The payments are generally a predefined percentage of the aircraft cost and can represent the advance payment of up to approximately half of the aircraft's

delivery cost. The advanced delivery deposits are also known as purchase deposits and are intended to help the manufacturer finance a portion of the aircraft construction costs. Advanced delivery deposits are qualifying assets, and interest related to these payments should be capitalized as part of the cost of the aircraft until the aircraft has been delivered and is ready for its intended use (as required by FASB Statement No. 34) and appropriate disclosures should be made. Please refer to the "Depreciation" section in this chapter for a discussion of when depreciation of aircraft, including capitalized interest, should begin.

4.24 Changes in passenger demand and the effects of certain geopolitical events can cause airlines to reduce capacity or alter their capacity plans for future years. One of the ways an airline can reduce capacity is to either defer or cancel orders of aircraft. In the case of a delivery deferral, the progress payments made by the airline to the manufacturer generally remain on deposit and available for use against future deferred or committed deliveries, although the manufacturer may require the airline to forfeit deposits or pay penalties in consideration for agreeing to the deferral. Deposits are generally not refundable. As such, if the cancellation or deferral results in significantly more deposits with the manufacturer than necessary for firmly committed aircraft, the recoverability of the deposits, including related capitalized interest, should be evaluated in accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. In the event of an aircraft order deferral, consideration should be given to paragraph 17 of FASB Statement No. 34, which states that capitalization of interest should continue as long as all three criteria set forth in that paragraph are present, including "activities that are necessary to get the asset ready for its intended use are in progress." Accordingly, if an aircraft delivery is deferred for a significant period, the carrier should evaluate whether the asset is still being prepared for its intended use and whether capitalization of interest should continue.

4.25 Frequently, contracts contain provisions requiring the airline to forfeit its progress payments or pay a penalty, or both, in case of cancellation of aircraft on order. In practice, however, the airline will often negotiate with the aircraft manufacturer so that

the penalty is waived and only a portion of progress payments, if any, is forfeited, although an airline should carefully evaluate the substance of such agreements to determine if any provisions in them represent penalties. The penalty, if any, is generally recognized as an operating expense in accordance with the guidance in FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities.* FASB Statement No. 146 also provides guidance on determining the appropriate timing of recognition for any penalties associated with cancellation of aircraft on order. Under FASB Statement No. 146, a liability for the costs to cancel the order is recognized and measured at its fair value when the airline gives written notice of cancellation to the aircraft manufacturer within the notification period specified by the contract or has otherwise negotiated a termination of all or part of the order with the aircraft manufacturer. An airline should also evaluate the recoverability of associated purchase deposits and related capitalized interest. Generally, if purchase deposits are forfeited, such amounts, including related capitalized interest, are charged to operating expense as a component of the contract termination costs.

Developmental and Preoperating Costs

4.26 Developmental costs include costs related directly to the development of new routes (or extension of existing routes), such as advertising and promotion expenses, related travel and incidental expenses, and any expenses of regulatory proceedings. Preoperating costs include costs related directly to adding a new aircraft type to an airline's fleet, such as flight crew training, maintenance training, prerevenue flight expenses, insurance, and depreciation. SOP 98-5, *Reporting on the Costs of Start-Up Activities* (AICPA, *Technical Practice Aids,* ACC sec. 10,750), requires preoperating costs related to the integration of new types of aircraft and developmental costs (other than advertising costs) to be expensed as incurred. Advertising costs should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs* (AICPA, *Technical Practice Aids,* ACC sec. 10,590), which provides that advertising costs should be expensed either as incurred or the first time the advertising takes place, except in limited circumstances that generally do not apply in the airline industry.

Used Aircraft

4.27 Used aircraft are acquired in various conditions and at various times between overhauls. FASB Statement No. 34 provides that the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. Therefore, AcSEC believes that costs incurred by the airline for items such as interiors, painting, customer service equipment, and maintenance to bring the aircraft current and to conform the aircraft to an airline's maintenance program prior to placing the aircraft or engine into service should be capitalized as a cost of preparing the asset for service. Similar to newly purchased aircraft, interest cost related to the acquisition of used aircraft should be capitalized until the aircraft is ready for its intended use as specified under FASB Statement No. 34. However, once an aircraft is placed into service, any subsequent costs must be accounted for as maintenance.

Impairment of Long-Lived Assets

4.28 Airlines frequently decide to either decrease capacity by removing certain aircraft from service on a temporary or permanent basis or, for strategic reasons, to realign their fleets with a new mix of aircraft. The airline's fleet plan is the primary source of information on the planned number of aircraft for the airline and includes information about new aircraft deliveries, anticipated retirements, and temporary groundings.

4.29 Aircraft can be removed from active service temporarily until they are needed to support operations. Temporarily grounded aircraft are parked and stored but are intended to be returned to service in the future. Temporarily grounded aircraft are treated like operating aircraft, and depreciation or rental expense should continue to be recognized.

4.30 Capacity decisions or changes in fleet structure can dictate that aircraft are no longer needed in the fleet. Permanently grounded aircraft are aircraft that will never return to active revenue service. FASB Statement No. 144 provides guidance on the

treatment of assets that are to be held and used and held for sale. According to FASB Statement No. 144, assets that are to be disposed of by sale should be accounted for as held for sale only if they meet all of the following criteria set forth in the standard:

- Management, having the authority to approve the action, commits to a plan to sell the asset.
- The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets.
- An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated.
- The sale of the asset is probable and the transfer of the asset is expected to qualify for recognition as a completed sale, within 1 year, with some limited exceptions to the 1-year requirement provided in paragraph 31 of FASB Statement No. 144.
- The asset is being actively marketed for sale at a price that is reasonable in relation to its current value.
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

4.31 An aircraft would generally have to be permanently grounded in order to meet the definition of *held for sale* because the complexity of fleet movements and scheduling make it unlikely that an aircraft in service would meet the definition of *available for immediate sale*. Aircraft classified as held for sale should be recorded at the lower of carrying amount or fair value less the cost to sell.[6] The difference between carrying amount and fair value less the cost to sell should be recognized as an impairment charge in the period the aircraft meets the held-for-sale criteria. AcSEC believes that such impairment charges should be included in operating income for both operating and

6 At its May 31, 2006, meeting, in connection with its project on business combinations, the Financial Accounting Standards Board (FASB) decided to amend FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* to replace *fair value less cost to sell* with *fair value*.

nonoperating aircraft. No further depreciation or amortization should be recorded on an aircraft that is classified as held for sale. Changes in the fair value less the cost to sell should be recognized as gains or losses in the period of change, and the asset's carrying amount should be adjusted for both increases and decreases, provided that the asset's carrying amount does not exceed its carrying amount as of the date the aircraft was classified as held for sale.

4.32 Any aircraft that does not meet the criteria of held for sale should be considered as held and used until the asset is disposed of. FASB Statement No. 144 requires that a long-lived asset (or assets grouped at the lowest level of identifiable cash flows) to be held and used be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. An impairment loss shall be recognized only if the carrying amount of a long-lived asset (or asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (or asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (or asset group). That assessment shall be based on the carrying amount of the asset (or asset group) at the date it is tested for recoverability, whether in use or under development. An impairment charge shall be recognized for the amount by which the carrying amount of a long-lived asset (or asset group) exceeds its fair value. Such impairment charges should be included in operating income.

4.33 The following table summarizes the different accounting models and treatments for nonoperating aircraft once the aircraft are either temporarily or permanently grounded by an airline.

Disposition Status	**Accounting Treatment**	**Timing of Accounting**
Temporarily Grounded	Continue to depreciate and consider the need to	Date of Decision

This guide will be updated to reflect this decision when FASB Statement No. 144 is officially amended.

	complete a held for use impairment analysis	
Permanently Grounded—Held for Sale (this also includes aircraft to be disposed of by sale of usable parts)	Stop depreciation and conduct a held for sale impairment analysis	Date of Grounding[1]
Permanently Grounded—Abandon	Stop depreciation and write down to salvage value	Date of Grounding[1]
In-Service—Decision made to market aircraft for sale or abandon at a fixed date	Held for use impairment analysis—accelerate depreciation to estimated salvage value at planned disposal date[2]	Date of Decision

[1] An impairment indicator would most likely occur prior to the actual grounding.

[2] AcSEC believes that aircraft still in operation for an airline will not meet held-for-sale criteria unless use of the aircraft is extremely limited (for example, being used as spare aircraft and not actively scheduled).

4.34 At the point a decision is made to permanently ground an aircraft that is not intended to be sold and, therefore, does not meet the held-for-sale criteria of FASB Statement No. 144, an impairment evaluation should be performed. In addition to the possible impairment charge, the remaining depreciable life and salvage value of the aircraft should be adjusted to reflect the last expected in-service date in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*. Once removed from service, a permanently grounded aircraft is classified as a long-lived nonoperating asset and no longer depreciated (at that point the aircraft should be fully depreciated to its salvage value). Furthermore, a permanently grounded aircraft that is not intended for sale may be stripped of usable parts. These usable parts from such aircraft are recorded in rotable parts at their fair value, with the aggregate value of the parts not to exceed the carrying amount of the aircraft at the time it was permanently grounded. In the event the

fair value of the individual parts exceeds the carrying amount of the aircraft, the carrying value of the aircraft should be allocated to the parts based on their relative fair values.

Impairment Indicators

4.35 The following are examples of events or changes in circumstances that may indicate impairment:

- Disposal or planned disposal of an entire fleet or a major portion of a fleet

- Management's commitment to permanently ground a fleet (or a major portion of a fleet) that is currently operating

- Significant fleet plan changes, including new aircraft orders

- Operational downsizing

- Adverse changes in the way the aircraft are being used, affecting cash flows (for example, significant reductions in fleet-wide aircraft utilization rates)

- Permanent and significant declines in fleet fair values

- Significant changes in the anticipated time period that a fleet will be used by the airline

- Significant changes in cash flows

- Regulatory changes and requirements that affect an airline's ability to operate its

aircraft

4.36 When an asset group (for example, a fleet of aircraft) is tested for recoverability, it also may be necessary to review estimates of remaining useful lives and salvage values of those aircraft, regardless of whether an impairment is recognized. Changes in depreciation from changes in estimated remaining useful lives or salvage values should be recognized prospectively in accordance with FASB Statement No. 154.

Cash Flows

4.37 A long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Identifying the group of assets at which cash flows are largely independent requires judgment; however, most passenger airlines have concluded that each aircraft type (and potentially each aircraft model) provides largely independent cash flows. When making the determination of how to group aircraft and related fleet assets (that is, rotable parts, leasehold improvements, and expendable parts that are used by a particular fleet and are considered part of the asset group; see the "Related Fleet Assets" section of this chapter for further discussion) for impairment testing, airlines should consider whether a particular fleet depends on another fleet for connecting traffic (for example, a short haul flight feeds traffic to longer haul connecting flights) and whether it is necessary to combine those fleets for impairment testing. While cash flows for specific aircraft may be obtainable, it is generally not practical to evaluate cash flows at this level due to the interchangeability of aircraft in an airline's operations, unless the aircraft is not interchangeable with other aircraft in the airline's fleet. Cargo airlines' cash flows are typically assessed at the network level due to the significant integration of the short haul and long haul cargo operations.

4.38 Estimates of future cash flows should include all future revenues expected to be collected net of costs expected to be paid. This is generally accomplished using data from an airline's route profitability system, which allocates revenue to flights based on

prorated fares or some other metric and expenses based on the nature of the expense and, if necessary, an allocation basis (such as available seat miles and passengers boarded). For passenger airlines, earnings can include the effects of both downstream and upstream revenues (for example, the value of connecting passengers on a short haul flight that feeds traffic to longer haul connecting flights) and include onboard passenger revenue, onboard cargo revenue, and other in-flight revenue. If an airline elects to use upstream and downstream revenue in its analysis, it must consistently show that total revenue to all flights does not exceed total external revenues from operations. Variable costs associated with the operation of the aircraft include items such as fuel, passenger variable expense, cargo variable expense, direct capacity expense, and variable overhead (training, ramp services, and line maintenance). Fixed costs include items such as aircraft rent, maintenance facilities and station rent. Undiscounted cash flow assumptions should be further adjusted to reflect the effect of future events, such as planned fleet changes, projections of passenger yield, anticipated fluctuations in the market price of jet fuel, labor costs, and other relevant factors in the markets in which the fleet operates.

4.39 When a fleet comprises both owned aircraft (including aircraft under capital leases) and aircraft under operating leases, fleet level cash flows include the full ownership cost of the leased aircraft (that is, the full operating rent expense, which includes both capital cost and financing cost), while for owned aircraft and related fleet assets, only the capital cost should be assessed for recoverability. As a result, cash flows for the entire fleet will be determined, inclusive of the rental payments for leased aircraft, and compared to the carrying value of the assets in the asset group (that is, owned aircraft and related fleet assets) in the impairment assessment under FASB Statement No. 144. If the carrying value of assets in the asset group exceeds the sum of the expected future cash flows, then the airline must measure the fair value of the fleet to determine whether an impairment loss should be recognized on any or all of the assets in the asset group. However, an impairment loss will reduce only the carrying amounts of the owned aircraft and related long-lived fleet assets in the asset group (expendable parts would be included in the asset group, but they would not be subject to impairment because they are not

long-lived assets; see the “Related Fleet Assets” section in this chapter). The loss is allocated to the owned aircraft and related long-lived fleet assets in the asset group on a pro rata basis using the relative carrying amounts of the assets, except that the loss allocated to an individual asset shall not reduce the carrying amount of each asset below its fair value.

4.40 For example, group all assets related to a fleet type level (for example, B767-300ER and related fleet assets) and then estimate future cash flows based on earnings projections over the remaining operating life of the fleet. One way to perform this analysis is to select a representative base year (generally using the most recent history) and determine the earnings and expenses of the fleet in that base year. This net earnings amount becomes the basis for projecting future cash flows for each subsequent year the fleet will be in operation, factoring in the effects of the events noted previously, such as aircraft retirements and additions. The sum of future undiscounted cash flows over the life of the primary asset in the asset group (in this case, the owned fleet assets), inclusive of the rental payments for any leased B767-300ER aircraft, should then be compared to the carrying value of the owned B767-300ER aircraft and related assets in the fleet. If the owned assets’ carrying value exceeds the sum of the expected future cash flows, then the airline must measure the fair value of these assets to determine whether an impairment loss should be recognized on any or all of the long-lived assets in the fleet.

Fair Value

4.41 The fair value of an asset is the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date, as defined in paragraph 5 of FASB Statement No. 157, *Fair Value Measurements*. The determination of fair value should consider attributes specific to the asset, for example, the condition and/or location of the asset and any restrictions on its sale or use. A fair value measurement assumes the transaction to sell the asset occurs in the principal market for the asset or, in the absence of a principal market, the most advantageous market for the asset. A quoted price in an active market generally provides the most reliable evidence of

fair value and shall be used to measure fair value whenever available. However, because quoted market prices are often not available for used aircraft, the best information available must be used to estimate the value, including published sources and independent appraisals based on long-term use assumptions. Values ascribed to distressed sales or forced liquidations should not be used nor should those obtained as part of a debt financing arrangement, except for comparative purposes in conjunction with other market indicators. Recent and proposed transactions, such as sales of similar aircraft and engine types, should be reviewed when publicly available.

Recognition of Impairment

4.42 Assets evaluated for impairment under the held-for-use criteria, whose carrying amount is determined to be not recoverable and exceeds their fair value, should be written down to their fair value, which should be used as the new cost basis to continue to depreciate the aircraft over their remaining useful lives. Salvage values must also be re-evaluated in light of newly determined fair value.

Related Fleet Assets

4.43 When an airline tests its fleet for impairment as discussed in the "Cash Flows" section in this chapter, it includes the carrying value of the related rotable parts, leasehold improvements, and expendable parts that are used by the particular fleet as part of the asset group. For example, if certain rotable parts can only be used on the primary aircraft in the asset group, then an impairment analysis should include these assets as prescribed in FASB Statement No. 144.

4.44 Although expendable parts would be included in the asset group, they would not be subject to impairment (because they are not long-lived assets). However, they may be subject to net realizable value considerations if there will be excess or obsolete parts as a result of fleet-related changes that triggered the impairment evaluation. Please see the

"Spare Parts" section in this chapter for definitions and descriptions of rotable and expendable parts.

Leased Property and Equipment

4.45 The aircraft leasing market over the years has diversified into a sophisticated financial market, resulting in a number of complex leasing structures used by airlines to finance or re-finance aircraft acquisitions. An important driver in an airline's evaluation of a particular leasing structure is its tax status because many aircraft leasing structures are designed to transfer tax benefits to the lessor from the airline. Such benefit is then reflected in the lease rate received by the airline. Examples of some of the leasing structures used by the industry are:

- Leasing directly from a leasing company.

- Leasing from the aircraft manufacturer or an affiliate.

- Public or private equipment trust certificates (ETCs). Typically in these transactions, the aircraft is placed in a trust with an equity participant (other than the airline) and the trust issues debt to public or private parties to fund the remainder of the acquisition of the aircraft, which is then leased back to the airline (alternatively, the agreement between the trust and the airline can be structured as debt).

- Public or private enhanced equipment trust certificate (EETC) structures. These structures are initially the same as ETCs except that additional series of trusts are involved to modify the cash flows in order to provide for a number of credit ratings to improve the overall creditworthiness of the debt securities issued by the equipment trust. Depending on how the third-party investment is structured, EETCs generally result in either debt or an operating lease from the airline's

perspective.

4.46 All leases should be classified as either capital or operating in accordance with FASB Statement No. 13 and related interpretive guidance. Many complex leasing structures, however, may involve a variable interest entity (VIE). Depending on the structure of the arrangement, the equipment trusts in the ETC and EETC structures are generally VIEs, and, as a result, FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003),* should be considered prior to the application of FASB Statement No. 13 to the lease. For example, if the trust in an ETC or EETC leasing structure is a VIE and the airline is the primary beneficiary, then the trust would be consolidated by the airline, eliminating the need to evaluate the lease between the trust and the airline under FASB Statement No. 13. See Chapter 6 of this guide for further discussion of VIEs. Airlines should also evaluate whether ETC and EETC structures are subject to the sale-leaseback provisions of FASB Statement No. 28, *Accounting for Sales with Leasebacks.* FASB Statement No. 13 contains a number of definitions, and an airline should carefully review this standard and all of its amendments and interpretations when determining whether a lease should be classified as capital or operating. Classification of subleased equipment should be determined in the same manner as for other leases.

4.47 Once a lessee has the right to use or control physical access to the leased property, regardless of whether the leased property has been placed in service, the lease term has commenced and rent expense should be recognized. This includes any rental costs incurred during a construction period, as provided for in FASB Staff Position No. 13-1, *Accounting for Rental Costs Incurred during a Construction Period,* and applies to both new and used aircraft as well as ground facilities and equipment. Rentals should be allocated on a straight-line basis over the lease term as required by FASB Statement No. 13 and FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases with Scheduled Rent Increases,* which require that those leases with scheduled rent increases or uneven rental streams or any rent holidays be recognized on a straight-line basis over

the lease term unless another systemic and rational basis is more representative of the time pattern in which the leased property is used.

4.48 Some airlines provide the crew, fuel, maintenance, and other services necessary to operate the flight, along with the leased aircraft, to other airlines in what is referred to as a *wet lease* arrangement. Airlines should consider the provisions of EITF Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*, in connection with such arrangements. Under EITF Issue No. 01-8, if an arrangement contains a lease as well as other nonlease elements, the classification, recognition, measurement, and disclosure requirements of FASB Statement No. 13 should be applied to the lease element of the arrangement. Such leases should be classified and accounted for in accordance with the provisions of FASB Statement No. 13, as amended. Other elements of the arrangement not within the scope of FASB Statement No. 13 should be accounted for in accordance with other applicable generally accepted accounting principles.

Leasehold Improvements

4.49 A *leasehold improvement* is a permanent improvement or betterment that increases the usefulness of the leased property and will generally revert to the lessor at the end of the lease term. Airlines typically make improvements or modifications to leased aircraft. These costs should be evaluated to determine if they should be capitalized as leasehold improvements. In capitalizing leasehold improvements, consideration should be given to future maintenance or replacement events. As discussed in the "Depreciation" section in this chapter, airlines may account for certain flight equipment separately from the related aircraft because the assets have useful lives that are different from the life of the aircraft. Leasehold improvements should be amortized over the lesser of the useful life of the improvement or the lease term, as defined in FASB Statement No. 13. Additionally, when new leasehold improvements are capitalized, the unamortized balance of any previous leasehold improvements should be evaluated to determine if they have been replaced and therefore should be written off.

4.50 Much like for owned assets, an airline may incur costs after taking delivery of a leased aircraft to get the aircraft ready for its service to the airline. For new aircraft, these costs are frequently minimal and generally relate to certain BFE or other airline-specific equipment modifications. Capital asset additions installed on newly leased assets should be capitalized as leasehold improvements. Modifications to used aircraft that will be leased are likely to be more extensive and will frequently include additional costs to bring the aircraft current and to conform the aircraft to an airline's maintenance program, interiors, painting, and other customer service equipment. These items, if incurred by the lessee, may qualify for capitalization as leasehold improvements. However, FASB Staff Position No. 13-1 requires recognition of rent expense once a lessee has the right to use or control physical access to the leased property, regardless of whether the leased property has been placed in service.

4.51 Lessors sometimes provide incentives or allowances under an operating lease, which may include funding or reimbursing the lessee for the cost of leasehold improvements. Any such incentives should not reduce the leasehold improvements, but should be recorded as a deferred liability and amortized on a straight-line basis over the lease term as reductions in rent expense in accordance with paragraph 15 of FASB Statement No. 13 and the response to Question No. 2 of FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*. Leasehold improvements should be recorded at their full cost, regardless of who paid for them. TPA TIS sections 5600.16, "Landlord Incentive Allowance in an Operating Lease," and 5600.17, "Cash Flows Statement Presentation of Landlord Incentive Allowance in an Operating Lease" (AICPA, *Technical Practice Aids*), provide additional guidance on accounting for operating lease incentives.

Return Conditions

4.52 Aircraft lease agreements often contain provisions that require an airline to return aircraft airframes and engines to the lessor in a certain maintenance condition or pay an

amount to the lessor based on the airframe and engine's actual return condition. Typically, an aircraft is expected to be returned at "half time," which presumes that at least 50 percent of the eligible flight time since the last overhaul remains when the aircraft is returned to the lessor. Generally, there are three ways an airline can satisfy its obligations under such leases: (*a*) performing maintenance (either internally or by contracting a third-party service provider) to return the aircraft to the level of maintenance required by the contract, (*b*) paying cash to compensate the lessor if the aircraft is returned with less flight time remaining than specified under the lease, and (*c*) swapping owned components (or other leased components) for leased components (engines).

4.53 Return conditions should be considered in the airline's policy of accounting for overhauls. The effect will vary according to the maintenance accounting method used and the terms of the individual lease agreements. The objective is to avoid having either unamortized overhaul costs or an unneeded accrual on the books when the aircraft is returned. Unamortized overhaul costs are amounts capitalized under either the deferral or built-in overhaul methods of accounting for aircraft maintenance that have not been fully amortized to expense at the time the aircraft is returned to the lessor. AcSEC believes lease return costs should be accounted for in a manner similar to the accounting for contingent rent, that is, recognized over the remaining life of the lease in accordance with EITF Issue No. 98-9, *Accounting for Contingent Rent*. The objective is to recognize the expense for lease return costs as the related aircraft hours accumulate, beginning when it is probable that such costs will be incurred and they can be estimated. The specific methods used to achieve this objective depend on the circumstances.

4.54 AcSEC believes, due to the nature of these agreements, incurrence of lease return costs becomes probable and the amount of those costs can typically be estimated near the end of the lease term (that is, after the aircraft has completed its last maintenance cycle prior to being returned). Because it is presumed that the lessee would select the most economical way to satisfy its obligation, the amount the airline should recognize as a

contingent rent expense is the lesser of (*a*) the contractual cash settlement to the lessor in accordance with the terms of the lease or (*b*) the estimated cost of the major overhaul. In situations in which the airline would receive a refund from the lessor if the eligible flight time remaining since the last overhaul was in excess of the minimum lease return condition required by the lease, the amount of the refund, if any, should be considered in the measurement of the contingent rent expense. That is, assuming an airline has determined it is probable that lease return costs would be incurred, the lesser of the estimated net payment (payment for maintenance less the portion anticipated to be received from lessor) or lease return costs (assuming the maintenance was not performed) would be accrued over the remaining term of the lease. However, an airline would not record a receivable from the lessor in the event a net refund is anticipated. Often, an airline will choose to satisfy lease return conditions by swapping engines as part of its overall engine maintenance program. AcSEC believes that a lease return liability would not need to be accrued if an airline has the intent and ability to satisfy lease return conditions through swapping engines and if those swaps lack commercial substance, as described in FASB Statement No. 153, *Exchanges of Nonmonetary Assets*. However, if it is concluded that the swaps have commercial substance, AcSEC believes that a lease return liability would need to be accrued. If the airline uses either the deferral or built-in overhaul method of accounting for planned major maintenance activities, unamortized maintenance would be written off when the engine is swapped.

Maintenance Deposits

4.55 Under the terms of most aircraft lease agreements, the airline, as lessee, is legally and contractually responsible for maintenance and repair of the leased aircraft throughout the lease term. However, in order to financially protect the lessor in the event the airline does not properly maintain the aircraft, some aircraft lease agreements include provisions that require the airline to make deposits with the lessor (frequently referred to as maintenance reserves or supplemental rent in the lease agreements). These amounts are typically calculated based on a performance measure, such as flight hours or cycles, and are contractually required to be reimbursed to the lessee upon the completion of the

required maintenance of the leased aircraft. If there are sufficient funds on deposit to reimburse the airline for the maintenance incurred by the airline, the lessor reimburses the airline for the maintenance. However, reimbursement is generally limited to the available deposits associated with the specific maintenance activity, and the lessors are not financially obligated to any outside maintenance providers. Regardless of whether there are available reimbursable deposits, the airline remains legally responsible for maintaining the leased aircraft throughout the lease term pursuant to the applicable provisions of the leases. Finally, some of the lease agreements provide that if there are excess amounts on deposit at the expiration of the lease, the lessor is entitled to retain such excess amounts, whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the airline.

4.56 FASB Statement No. 13 excludes a lessee's obligation to pay executory costs, including maintenance, and any profit thereon from the determination of minimum lease payments and other calculations required under FASB Statement No. 13. As a result, these lease provisions require close analysis to determine if they relate to maintenance and therefore whether they should be accounted for in accordance with the airline's maintenance accounting policy. If the payments relate to maintenance and do not meet the risk transfer criteria discussed in the "Outsourcing Maintenance" section of this chapter, AcSEC believes the payments should be recorded as a deposit or prepaid expense to the extent recoverable through future maintenance activities. When the underlying maintenance event occurs, it would be accounted for as maintenance expense or capitalized in accordance with the airline's maintenance accounting policy. Nonrefundable amounts that are not probable of being used to fund future maintenance activities would be recognized as expense.

Lease Termination

4.57 Terminating aircraft operating leases early or permanently ceasing operations of aircraft financed under operating leases commonly occurs in the airline industry. FASB

Statement No. 146 provides guidance on recognition and measurement of costs associated with terminating an operating lease and the reporting and disclosure of such costs.

4.58 In the case of ceasing operations of a leased aircraft, a liability for costs that will continue to be incurred under the lease for its remaining term without economic benefit to the airline should be recognized and measured at fair value when the airline ceases using the aircraft, which is generally the point when the aircraft is permanently removed from operations. The fair value of this liability shall be determined using an appropriate valuation technique (the present value of the remaining lease payments is often the best available valuation technique) and shall be reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease. Accretion of the liability should be recorded as an operating expense as required by FASB Statement No. 146.

4.59 In the case of early termination, a liability for costs to terminate the lease (for example, a termination penalty) shall be recognized and measured at its fair value when the airline terminates the lease in accordance with its terms (for example, when the airline gives written notice to the lessor within the notification period by the contract or has otherwise negotiated a termination with the lessor). Appendix A of FASB Statement No. 146 provides an example (Example 4) of how to calculate costs associated with terminating an operating lease. Disclosure would be appropriate if the decision to terminate has occurred but the conditions for accrual have not yet been met.

Capacity Purchase Agreements

4.60 Certain agreements between regional airlines and their major airline partners that stipulate for the regional to provide aircraft capacity to the major are considered leases pursuant to EITF Issue No. 01-8. Generally, just the aircraft portion of a capacity purchase agreement would qualify as a lease under EITF Issue No. 01-8. The provisions

of the regional capacity purchase agreement should be evaluated under EITF Issue No. 01-8 when the arrangement provides for specific aircraft acquisition reimbursements to the regional airline. Chapter 9 discusses criteria that need to be considered when determining whether a capacity purchase agreement contains a lease. The lease portion of the capacity purchase agreement should be accounted for and classified in accordance with FASB Statement No. 13. Additionally, as discussed in Chapter 6, capacity purchase agreements with regional airlines should be evaluated under the requirements of FASB Interpretation No. 46R to determine if they cause the regional airline to be considered a variable interest entity.

Depreciation

4.61 The objective of depreciation accounting is to allocate the cost of a capital asset over its expected useful life in a manner that best represents the pattern of consumption of the expected benefits. Recently, some airlines have begun accounting for certain flight equipment, primarily customer service assets such as seats and in-flight entertainment equipment, separately from the related aircraft because those assets have lives that are different from the life of the aircraft. Airlines can use any depreciation method permitted by generally accepted accounting principles that reflects the pattern of consumption of the asset being depreciated, although the most prevalent in the industry is straight-line depreciation. Generally, a depreciation method applied on an operating measure such as flight hours would not be appropriate because it would allow suspension of depreciation of temporarily grounded aircraft. An airline may change its depreciation method only if the new depreciation method is justifiable on the basis that it is preferable. For example, an entity that concludes that the pattern of consumption of the expected benefits of an asset has changed and determines that a new depreciation method better reflects that pattern may be justified in making a change. FASB Statement No. 154 requires that a change in depreciation method be accounted for as a change in accounting estimate that is effected by a change in accounting principle. Please refer to paragraphs 19–22 of FASB Statement No. 154 for additional guidance.

4.62 Depreciation begins when the asset is placed in service, which generally coincides with the date when the asset is ready for its intended use. Depreciation continues until the asset is permanently removed from service. If an aircraft is temporarily out of service (temporarily grounded) due to labor strikes, lack of traffic, maintenance, or other reasons, depreciation of the aircraft should continue. If an airline commits to a plan to permanently ground an asset before the end of its previously estimated useful life but continues to operate the asset, depreciation estimates shall be revised in accordance with FASB Statement No. 154 to reflect the use of the asset over its shortened useful life. However, the asset may be subject to an impairment charge as a held-for-use asset if anticipated undiscounted cash flows over the estimated life are less than the carrying amount of the asset (refer to the "Impairment of Long-Lived Assets" section in this chapter for a discussion of impairment). Aircraft to be held and used for which an impairment loss has been recognized shall be accounted for at its new cost (fair value), with depreciation recognized over the asset's remaining useful life. As provided in FASB Statement No. 144, an asset that meets the held-for-sale criteria is not depreciated.

4.63 Airlines' fixed assets that have significant unit costs and are comparatively few in number, such as aircraft, engines, and other identifiable assets, are generally depreciated on an individual basis. Rotable and certain other spare parts may be depreciated on a pooled basis as discussed in the following section.

Depreciation of Rotable and Certain Other Spare Parts

4.64 Rotable and certain other spare parts, such as certain repairable parts, that are fairly homogeneous and significant in number but have relatively small unit values may apply depreciation on a pooled basis.[7] Under this method, depreciation is recorded based upon a pool of similar assets. Because these parts typically support one fleet type, they are generally pooled according to the fleet they support (issues surrounding the

7 Please note that this depreciation method, as described in this guide, is different from a method known as the group-life and mass-asset method of accounting that is applied to large groups of homogeneous assets and primarily used in the utility, telecommunications, and railroad industries.

classification of rotables and other spare parts are discussed in the "Spare Parts" section of this chapter). The pool is then depreciated over the remaining life of the fleet. This is done by taking the cost of the assets in the pool and subtracting out the salvage value and the accumulated depreciation to arrive at the remaining depreciable basis. The remaining depreciable basis is then divided by the remaining life of the applicable fleet to arrive at depreciation expense for the period. Also, when these parts are scrapped, either because they are beyond economic repair or lost, the cost of the scrapped asset is written off against the accumulated depreciation for the fleet type. In establishing lives for depreciation, a fleet life is typically used. The fleet life is calculated from the date that the first aircraft was put into service through the anticipated fleet retirement date.

Estimated Useful Life and Salvage Value

4.65 The period over which an asset is depreciated (its estimated useful life) and its estimated salvage value are determined on the basis of many factors. Aircraft are maintained in relatively the same condition throughout their service lives; therefore, property and equipment are replaced primarily because of market growth, technological developments, operating cost efficiency, and revenue-generating capability. Because such factors may affect each airline in a different way, different airlines often have different estimated useful lives for the same type of equipment. Salvage values for the same type of equipment also vary among airlines for the same reason. The determination of aircraft lives and salvage values also varies according to each company's projections of when the aircraft will be replaced, its ability to finance replacements, length of flights, number of takeoffs and landings, and similar factors affecting the cost of maintaining aircraft in flying condition. The lives of certain parts can vary from the original airframe life. For example, aircraft interiors, in-flight entertainment equipment, and other customer service related assets may be separately depreciated over a shorter life than the aircraft to which they relate due to frequent updating or changes to such equipment**.** As discussed in the "Aircraft Modifications" section of this chapter, if an airline has a history of replacing such parts before they are fully depreciated, the airline should consider assigning separate shorter useful lives to those parts. In general, the salvage

values for aircraft range from zero percent to 20 percent of original cost, depending on the age of the fleet, industry usage trends, and technological advances.

4.66 Ground assets consist of ramp equipment, furniture, and other miscellaneous office equipment. The lives for these types of assets also vary among air carriers. In general, the industry assigns zero salvage values and lives ranging between 2 and 15 years for these types of assets.

Amortization of Leasehold Improvements

4.67 Leasehold improvements should be amortized over the lesser of the useful life or the lease term. TPA TIS sections 5600.14, "Amortization/Depreciation of Leasehold Improvements in an Operating Lease," and 5600.15, "Leasehold Improvements and Lease Term in an Operating Lease" (AICPA, *Technical Practice Aids*), provide additional general guidance on determining the period over which a lessee should amortize leasehold improvements.

4.68 Airlines execute leases with airport authorities for use of the gates, terminals, landing rights, and other operating needs. At some airports, lease terms are often month to month, or on a shorter term basis, and do not contain renewal provisions. The practice of using shorter term leases is often due to the airports' experience with bankrupt carriers for which underutilized long term airport leases at favorable terms were a key asset controlled by bankrupt carriers and were, therefore, outside the control of the airport authority. Additionally, given the complexity of airport leases, carriers may be on a month to month lease during the negotiation period of a new longer term lease. As a result of this practice, close examination is required to determine the lease term, as defined in paragraph 5 of FASB Statement No. 13 (as amended by paragraph 22 of FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct*

Costs of Direct Financing Leases). Airport leases differ from traditional commercial leasing relationships in several ways, including the following:

- An airline has no choice but to execute a lease at the airport with the airport authority. If the airport authority has a desire to keep the lease at 30 days, that is solely in its prerogative to do so. There are no alternative facilities in which the airline can operate (that is, there is no similar retail space down the street).

- Airports are run by governmental entities (generally affiliated with the local city or county government or a separately established airport governmental authority). These entities are generally not-for-profit entities that pass their cost to the users of the airport.

- The FAA regulates the right for U.S. domestic airlines to fly between any two cities in the United States and under the Airline Deregulation Act of 1978, a domestic airline may choose to fly between any two cities in the United States (subject to slot restrictions at a few airports).

- While an airline will typically execute various agreements of varying terms with an airport authority, ultimately, as a result of various federal regulations, an airport authority legally may not restrict use of its airport to an airline. By accepting federal money, airports have covenanted to the FAA that the airport will be open to all carriers on "reasonable conditions without unjust discrimination" [49 USC, Section 47107(a)(1)]. The Department of Transportation and FAA have stated in interpretation of this law that preventing or impeding "a carrier's service at an airport is inconsistent with the airport's contractual grant assurances to provide reasonable and not unjustly discriminatory access to the airport and not to grant an exclusive right at the airport" [*Airport Business Practices and Their Impact on Airline Competition*, FFA/OST Task Force Study (October, 1999), p. 13]. Airlines

believe this legal interpretation effectively prevents the airport authority from terminating the rights of the airline to operate at the airport as long as the airline continues to choose to operate at the airport. Under this statute, the airline has to be provided access to equivalent space to conduct its existing operations.

- No history exists where an airline has been removed from its space at an airport location at the expiration of its lease, absent its choice to leave, or except in cases where the airport authority has determined that the space is underutilized and has taken action to recover underutilized space from the airline.

- Airlines have a long history of operating at airports on short term leases without stated renewal rights that have, in effect, renewed continuously. In addition, although an airline may be asked to share its space (especially if it is underutilized) or, in rare cases, move space at an airport to another location, this happens very infrequently. Historically, if an airline is asked to move to accommodate another airline, the other airline would normally compensate the moving carrier for its costs, including leasehold improvement costs that may not otherwise be recovered.

4.69 Based on the factors described in the preceding paragraph, airlines have concluded that a legal right exists for the airlines to stay at the airport past their contractually stated lease term. Despite the existence of a stated lease term, the airlines believe the airport authority cannot legally enforce the lease terms and remove the airline from the airport facility unless the facility is being underutilized by the airline. Therefore, the airlines have, in substance, renewal options to remain at the airport past the stated lease term. In such situations, AcSEC believes it is appropriate to have an amortization period in excess of the stated contractual term (but no longer than the useful life of the leasehold improvement) if all of the following criteria are met:

- The airline reaches a supportable legal conclusion that the rights granted to the

airlines by the FAA or the appropriate international aviation authority under the law legally prevent the airport authority from removing the airline from its operations upon expiration of the stated contractual lease term, except in circumstances where the facilities are underutilized, which results in the airline's ability to continue and renew the lease at its discretion.

- Failure of the airline to exercise its rights to these renewals would impose a penalty (as defined in paragraph 22(b) of FASB Statement No. 98) on the airline and, therefore, the renewal is reasonably assured (as defined in paragraph 22(a) of FASB Statement No. 98).

- Substantially equivalent space is not available for the airline's use at another location at the airport.

4.70 If the criteria described in paragraph 4.69 of this chapter are met, the reasonably assured renewals would be included in the lease term in determining the period over which the leasehold improvements should be amortized.

Aircraft Maintenance

4.71 Maintenance requirements are dictated by the highly sophisticated nature of the industry's equipment. The FAA or other regulatory agencies have established repair and overhaul cycles for each airframe and engine part in an effort to prevent potential hazards and to ensure transportation safety. The timing and extent of maintenance procedures are determined by individual airlines using studies based on actual experience, which demonstrate airworthiness to the FAA or other regulatory agencies. Maintenance is performed after an aircraft is placed into service to keep it operating.

4.72 An airline's maintenance program includes three general categories: line maintenance, component overhaul and repair, and maintenance checks. Line maintenance

consists of routine daily and weekly scheduled maintenance inspections and checks, including pre-flight, daily, overnight, and weekly checks, and any diagnostics and routine repairs. Some or all of these activities may be outsourced by the airline to a third-party provider.

4.73 Component overhaul and repair involves the repair of parts, including engines, landing gear, and avionics, that are either repaired in-house or sent to third-party FAA-approved maintenance repair stations. Overhauls encompass all inspections or replacements of major parts, which the FAA requires at specific maximum periodic intervals to recertify that the part is completely airworthy. However, an overhaul does not include the cost of routine replacement of minor parts and servicing or inspection of airframes and aircraft engines. Also excluded from overhauls are costs accounted for as restoration of assets, such as extraordinary costs associated with the renewal of major structural parts beyond the scope of normal periodic overhauls, and other costs with a life span similar to the depreciable service life of the related airframe or aircraft engine.

4.74 Maintenance checks consist of more complex inspections and servicing of the aircraft that cannot be accomplished during an overnight visit. These occur at predetermined levels as set forth in an airline's maintenance program and can range in duration from a few days to approximately a month, depending on the magnitude of the work prescribed in the particular check. Planned major maintenance activities or major overhauls of engines are all part of this category.

Expense Recognition

4.75 The cost of line maintenance and other routine repairs, whether performed by the airline or outsourced to a third-party provider, should be expensed as incurred. However, there are three acceptable methods of accounting for planned major maintenance activities performed under established programs for regulatory compliance related to

different fleet types and for engines, airframes, or major components of the same aircraft type. These methods are described in the following paragraphs.

Expense as incurred method

4.76 Under this method, all maintenance costs are expensed in the period incurred because maintenance activities do not represent separately identifiable assets or property units in and of themselves; rather, they serve only to restore assets to their original operating condition.

Deferral method

4.77 Under this method, the actual cost of each planned major maintenance activity is capitalized and amortized to expense in a systematic and rational manner over the estimated period until the next planned major maintenance activity.

Built-in overhaul method

4.78 Under this method, costs of activities that restore the service potential of airframes and engines are considered a component of the asset. This method cannot be applied to leased aircraft. The cost of airframes and engines (upon which the planned major maintenance activity is performed) is segregated into those costs that are to be depreciated over the expected useful life of the airframes and engines and those that represent the estimated cost of the next planned major maintenance activity. Thus, the estimated cost of the first planned major maintenance activity is separated from the cost of the "remainder" of the airframes and engines and amortized to the date of the initial planned major maintenance activity. The cost of that first planned major maintenance activity is then capitalized and amortized to the next occurrence of the planned major maintenance activity, at which time the process is repeated.

4.79 AcSEC believes the expense as incurred method is preferable to all other methods of accounting for maintenance activities.

4.80 For parts sent to third-party FAA-approved maintenance repair stations for overhaul or repair or both, under the expense as incurred method the estimated cost of maintenance should be accrued over the period of repair. In certain cases, however, airlines may not be able to account for those costs over the period of repair due to lack of necessary information on a timely basis or other practical considerations. As a result, airlines have developed simplified conventions that reasonably approximate the costs incurred over the repair period, which include accounting for the cost of the maintenance (*a*) when parts are shipped to the third-party vendor, (*b*) upon receipt of shop estimates from the third-party vendor, or (*c*) when the maintenance work is completed. All of these options with third-party maintenance repair stations are considered acceptable as long as the airline chooses one approach and applies it consistently and as long as the results do not materially differ from the results obtained by accruing the costs over the period of repair.

Outsourcing Maintenance

4.81 Historically, most major airlines performed maintenance on their own aircraft in-house. They traditionally had sufficient fleet sizes to keep the maintenance and repair operations scheduled to full capacity for the entire year. With the advent of low-cost carriers and regional airlines (which fly only feeder traffic for their major network airline partners), many airlines began to use independent maintenance providers to provide more flexibility and reduce costs. The process lends itself to outsourcing because the maintenance activities are routine in nature and occur under established programs that are pre-approved by the FAA for carriers operating in the United States. A number of airlines (including some major airlines) outsource some or all of the scheduled maintenance activities that must be performed on the engines and airframes they operate.

4.82 Generally, two types of contracts are used to provide these services: (*a*) time-and-material and (*b*) power-by-the-hour (PBTH) contracts. Traditional time-and-material contracts may fix certain components of the cost, but much of the contract price is based on actual cost at the time the maintenance event takes place. To accommodate the airlines' desire to fix their costs, and partially as a tool used by the airframe and engine equipment manufacturers to sell their ongoing maintenance services, PBTH contracts were developed. Under PBTH contracts, airlines generally pay the service provider a fixed amount per flight hour in exchange for required maintenance and repairs under the predefined maintenance program. These contracts generally provide that, in exchange for a payment of a fixed amount per flight hour or other applicable unit of measurement associated with the aircraft (for example, block hour or cycle), the maintenance provider will provide specified maintenance activities associated with a particular aircraft for a specified period. PBTH contracts have many unique attributes but may include any of the following: (*a*) providing for a level fixed rate per flight hour without a provision for the flight hours accumulated at the contract commencement date, (*b*) containing a buy-in provision based on the flight hours accumulated to the point of entering into the PBTH contract, or (*c*) providing for an initial rate per flight hour that is lower than the rate per flight hour under the contract in the later period (usually related to new aircraft types).

4.83 PBTH contracts fix certain of the airline's costs and, therefore, transfer certain risks (including cost risk) associated with the maintenance activities to the service provider. One exception to the transfer-of-risk concept is that, under most of these contracts, the airline would continue to be responsible for foreign-object damages (FOD) or other items that were not within the scope of scheduled maintenance activities established initially. However, much like insurance contracts, an airline can include a predefined number of FOD events to be covered by the PBTH contract, generally based on the history of such events at the airline. In these cases, the FOD events that exceed a specified amount or tolerance are not covered by the contract and generally would be settled on a time-and-materials basis. Another exception is prospective rate adjustments for changes in the required maintenance program by the FAA or other rule makers or

regulatory changes, such as in the number of flight hours until the replacement of certain life-limited parts is required. If these events occur, the contract calls either for renegotiation of the rate per flight hour or for renegotiation of specified components of the rate per flight hour.

4.84 Some major airlines provide maintenance to regional airlines under PBTH arrangements. In addition, as discussed in the "Maintenance Deposits" section of this chapter, some lease agreements require deposits or supplemental rent be paid to the lessor to fund future maintenance of the leased aircraft or engine. It is expected that these arrangements will be also accounted for based on the criteria discussed in the following paragraphs.

4.85 AcSEC believes the issues relating to PBTH contracts and other similar arrangements with independent maintenance and repair providers include determining whether risk has been transferred to the service provider. The risk transfer criteria discussed in this section provide a framework for determining whether there is a transfer of risk. If the contract transfers risk, AcSEC believes the airline should recognize maintenance expense in accordance with the PBTH contract, as opposed to following its maintenance accounting policy. In these situations, there is a presumption that the expense should be recognized at a level rate per hour during the minimum, noncancelable term of the PBTH agreement. That presumption could be overcome by evidence that the level of service effort varies over time, consistent with the variations in the payment pattern under the PBTH contract. Expense recognition is discussed in detail in this section.

4.86 If a contract does not meet the risk transfer criteria, AcSEC believes the payments made under the contract should be recorded as a deposit or prepaid expense to the extent recoverable through future maintenance activities. When the underlying maintenance event occurs, it would be accounted for as maintenance expense or capitalized in accordance with the airline's maintenance accounting policy. Any nonrefundable

amounts that are not probable of being used to fund future maintenance activities should be recognized as expense. If the cost per event is not specifically determined from the contract, the airline would record maintenance expense based on the fair value of the underlying maintenance activities. The amount of maintenance expense recorded should be supported by evidential matter. Such support could include prior costs for similar maintenance activities, documentation from a maintenance provider or other third parties, or both. “Nonroutine” maintenance, including payments under contracts for FOD or other out of scope work, should also be expensed as it is incurred.

Risk Transfer Criteria

4.87 The determination of whether risks and rewards have been transferred to the service provider may depend on, among other things, the contract, the related rights and obligations of each party in the event of termination, and whether contract payments are refundable. This assessment should be made at inception of the contract or after the contract has been substantially modified. Because each PBTH contract has different terms and objectives, it is difficult to provide specific conditions for all contracts. However, the following principles should be considered in determining whether there is a transfer of risk (Exhibit 4-1 to this chapter provides a summary of contract provisions for five PBTH contracts and their effect on the determination of whether there is a transfer of risk).

- *True-ups.* For a transfer of risk to occur, the service provider must absorb and receive substantially all variability of the cost of maintenance required under the service contract. AcSEC believes that a contract with payment terms calling for payments that are intended to approximate substantially all of the actual costs, but that requires a true-up to actual costs incurred by the maintenance service provider (either at various points in the contract or upon termination), does not meet the risk transfer objective. In addition, rate reset provisions that call for prospective PBTH rate adjustments that effectively serve to recover or pay back based on

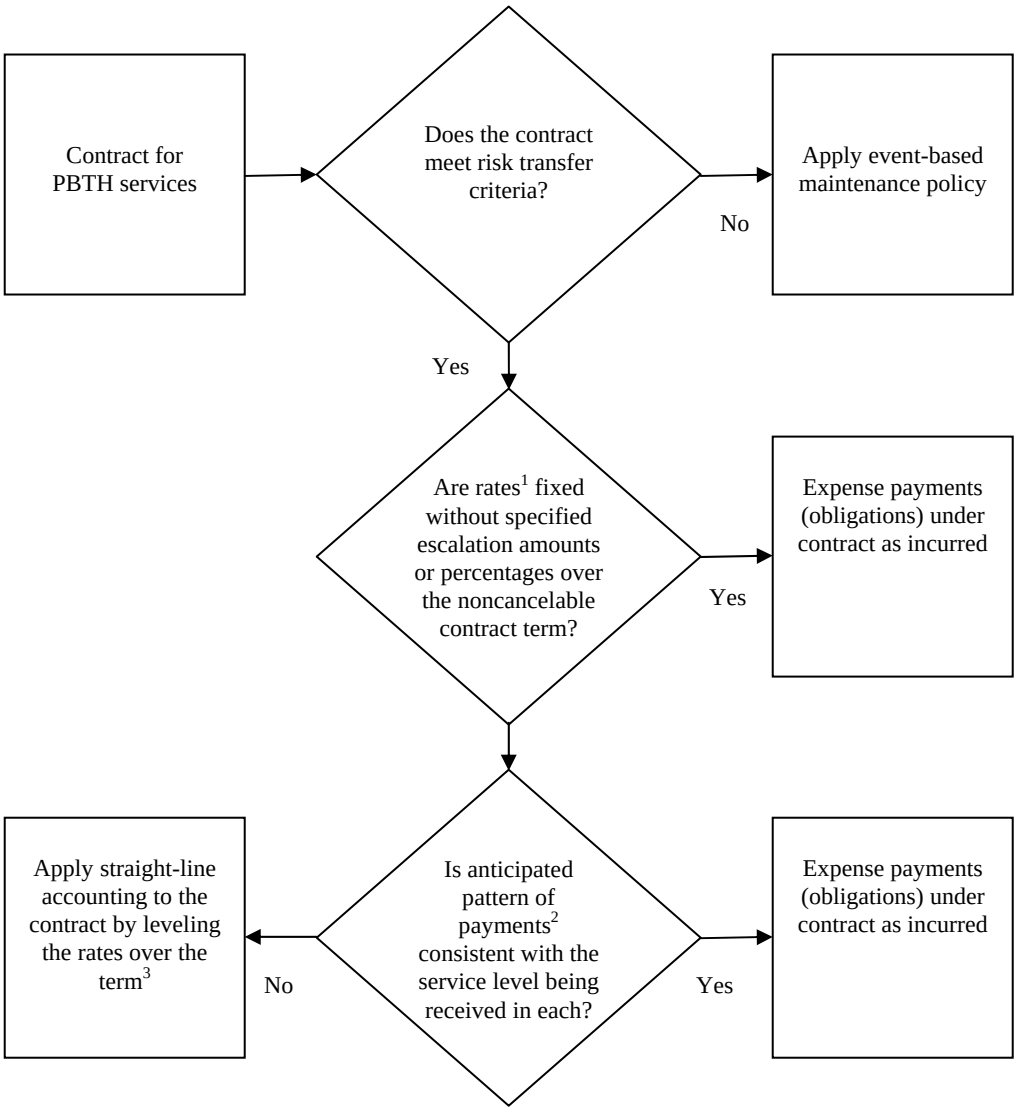
historical contract performance would not achieve this risk transfer objective.

- *Contract adjustment provisions.* The contract may provide for an adjustment payable by either party for out-of-scope work, including FOD and adjustments to the hours prior to the replacement of life-limited parts, and still transfer risk. However, a contract that simply includes cost true-up provisions based on the service provider's cost experiences does not transfer risk. Contracts may contain annual or periodic escalation provisions, either tied to specified inflationary or labor indices or specifically agreed to by the parties (including increases tied to certain performance criteria as long as they are capped or otherwise limited in allowing either party to mitigate the criteria in the previous bullet point) and still transfer risk, as long as they do not conflict with the other principles set forth in this section.

- *Termination provisions.* The contract may contain exit provisions for either party for cause or for other performance-related factors and still transfer risk as long as the contract does not result in the recovery of amounts paid or in the incurrence of any additional liability by the airline upon termination based on the relationship of contract payments to actual cost experience by the service provider or based on the relationship of payments made on a specific airframe or engine to work performed on that airframe or engine (cost true-up). However, the contract may reasonably provide for the successful satisfaction of each party's obligations under the contract that had been incurred prior to the termination and penalty provisions, if appropriate, and still transfer risk.

Expense Recognition

4.88 As previously mentioned, if risk has been transferred, AcSEC believes there should be a presumption that the expense should be recognized at a level rate per hour. However, changes in contractual rates that are adjusted based on an index, such as the Consumer Price Index (CPI), or that cannot be reliably determined at the outset of the contract would not be leveled. In situations where rates are adjusted for CPI but the adjustment cannot be less than a certain minimum (for example, 1.5 percent), expense should be recognized at a level rate per hour based on the minimum increase. For PBTH contracts with other than straight-line rates per hour, the presumption that expense should be recognized at a level rate per hour can be overcome by evidence that the level of service effort provided under the contract varies over time and that the changes in the contractual rate per hour are consistent with the changes in the level of service effort to be provided under the PTBH contract. Examples of such evidence include (*a*) detailed service level estimates prepared by the service provider that indicate the planned service level in each of the periods and (*b*) projections of major maintenance events that will be covered under the contract, which indicate significant changes in service levels. If such evidence exists, expense would be recognized based on the rates in the PBTH contract. The following flowchart provides a model for the evaluation of PBTH contract payment terms to consider the possible effect of straight-lining.



[1] Denotes the rate to be applied to the applicable usage measure in the contract (for example, flights, hours, or cycles).

[2] Implies rate specifics in the contract times estimated usage in each period.

[3] See Exhibits 4-3A through 4-3C for examples of the application of straight-line accounting to PBTH contracts.

4.89 This model applies the basic concept that expense should be recognized in accordance with the service level being received by the airline. Exhibit 4-2 in this chapter provides examples of how the model would be applied in various scenarios. If rates are not constant and an airline cannot conclude that the contractual payment terms reasonably match the service level expected to be received during the noncancelable term of the contract, then expense should be recognized on a straight-line basis over the noncancelable contract term. If there is a change in the variables used in the calculation of the periodic expense (that is, total number of hours expected to be flown over the contract period or the distribution of those hours among periods), such changes in estimates should be accounted for on a prospective basis in accordance with FASB Statement No. 154. An example of the PBTH rate calculation and leveling is included in Exhibits 4-3A–4-3C in this chapter.

Spare Parts

4.90 Spare parts are typically grouped into several broad categories: rotables, repairables, expendables, and materials and supplies. The following table provides brief descriptions of the categories and accounting guidance for each category.

Spare Parts Category	Accounting Guidance
Rotable parts typically are significant in value and can be repaired and reused such that they typically have an expected useful life approximately equal to the aircraft they support.	Consistent with paragraphs 3.117 and 3.120 of the 2003 edition of the AICPA *Audits of Airlines* Industry Audit Guide (the 2003 edition of the guide), rotable parts are capitalized and classified along with flight equipment as fixed assets. Rotable parts are normally depreciated over their useful lives or the remaining service lives of the related equipment. The cost of repairing rotables is charged to expense as it is incurred.
Repairable parts are repairable and reusable but with economic useful lives generally less than the aircraft they support and values less than most rotable parts.	AcSEC believes that repairable parts, along with certain life-limited rotable parts, can be classified as either expendables in current assets or as rotables in fixed assets. Repairable parts are normally depreciated over the lesser of their useful lives or the remaining service lives of the related equipment. The cost of repairing repairable parts is charged to

	expense as it is incurred.
Expendable parts cannot be economically repaired, reconditioned, or reused after removal from the aircraft.	Consistent with paragraphs 2.04, 3.117, and 3.121 of the 2003 edition of the guide, expendable parts are recorded as a current asset and are charged to expense as they are used or consumed in operations (that is, placed on an aircraft). Expendable parts are valued at cost, less an allowance for obsolescence.
Miscellaneous materials and supplies support flight or ground equipment.	Consistent with paragraphs 2.04 and 3.121 of the 2003 edition of the guide, miscellaneous materials and supplies are either classified with expendable parts in current assets or are expensed upon purchase. Classification of specific parts ordinarily depends on the carrier's maintenance program.

4.91 Because rotable parts are classified and considered fixed assets, the asset valuation of rotable parts is similar to that of other property and equipment. As replacement parts for rotable parts are purchased, they are capitalized. Rotable parts are normally depreciated over their useful lives or the remaining service lives of the related equipment. Airlines have traditionally depreciated these rotable parts on a pooled basis over the estimated service lives of the related aircraft. See the "Depreciation" section in this chapter for further details.

4.92 Rotable parts are generally acquired along with the aircraft, and the number of parts is dependent on the number of aircraft in the fleet, locations served, and other factors. They are called rotable parts because they rotate between the spare parts pool and the aircraft or engine. Examples of rotable parts include aircraft avionics, engine blades, and landing gears. Because rotable parts can be repaired and reused, they are serialized for tracking purposes. Due to FAA requirements, an airline is required to maintain records of the location of and the maintenance performed on each serialized rotable part. Airlines typically record this information within their maintenance systems.

4.93 Operationally, when a rotable part is installed on an aircraft, the old part is taken off and replaced with a similar part from the pool of rotable parts. The removed

unserviceable rotable part is repaired and then placed back in the spare parts pool for use on another aircraft after being made serviceable. The cost to repair the part is expensed as incurred. The aircraft and the related rotable parts continue to be depreciated over their estimated useful life. Until a rotable part is scrapped, it retains its functionality and just moves among various locations and aircrafts. When a rotable part is removed from service and scrapped, the cost of the scrapped rotable part is charged to accumulated depreciation, consistent with established depreciation policies.

4.94 Rotable, repairable, and expendable spare parts recovered in connection with construction, maintenance, or stripping retired aircraft of usable parts or other fixed asset retirements should be recorded at net realizable value. This valuation is typically based on the condition of the part or group of parts and the part's continuing utility. The average cost of comparable items is usually used as an estimate for net realizable value by the airlines. These parts are then depreciated (if they are classified as either rotable or repairable parts), or charged to expense when used (if they are classified as expendable parts).

Allowance for Obsolescence

4.95 Consistent with paragraph 2.04 of the 2003 edition of the guide, an airline establishes an allowance for obsolescence[8] to distribute the cost of expendable parts expected to be on hand at the end of a fleet's life over the service lives of the related equipment. In making this calculation, the airline can classify parts by type of aircraft. The airline also takes into account the estimated useful life of each type of aircraft fleet, the estimated cost of expendable parts expected to be on hand at the end of the useful life, and the estimated salvage value of the parts.

8 Please note that the term *allowance for obsolescence* is generally used in connection with inventory accounts. However, as used in this guide, this industry specific term has a different meaning and is related to expendable spare parts.

4.96 Because expendable parts supplies typically turn over numerous times during the useful life of an aircraft fleet, an airline can also manage, to some extent, the level of spare parts expected to be on hand at the end of the useful life of the fleet (referred to as base stock). Airlines often phase out fleets over several years. As these aircraft come out of service over that period, the airline can reduce the amount of expendable parts on hand by purchasing fewer parts and thus phasing these parts out by reduced purchasing. As a result, some airlines may conclude that the level of expendable parts on hand at the end of the fleet life will be less than the total net book value of expendable parts prior to the end of the fleet life. As a result, the obsolescence allowance computation may consider less than the entire expendable parts supply on hand at any point in time. For example, an airline may conclude that for a particular fleet, due to a long time period over which the fleet will be retired, only 50 percent of its current level of expendable parts will be on hand at fleet retirement and as such, only 50 percent of expendable parts is subject to an obsolescence allowance. AcSEC believes it is not reasonable for an airline to assume that it can dispose of its entire expendable parts supply prior to fleet retirement and not record an allowance.

4.97 Typically, the spare parts obsolescence provision for the period is calculated by taking the historical cost of the spare parts; reducing it by the estimated base stock, the estimated salvage value, and the current allowance for obsolescence; and then dividing the remaining amount by the remaining useful or average service life of the aircraft to which they relate.

4.98 In addition to this allowance, a separate evaluation is periodically made of expendable parts that are considered excess to the airline’s needs or surplus or obsolete due to engineering change orders, fleet changes, and so on. Once evaluated, additional obsolescence charges may be required for these excess or surplus or obsolete parts. Allowances should also be periodically reviewed for reasonableness in relation to changes in technology and changes in the estimated useful or service lives of the aircraft.

Inherent Risk Factors

4.99 In assessing audit risk, the auditor should consider those factors that influence inherent risk related to acquiring and maintaining property and equipment. Such factors might include:

- New aircraft acquisition contracts, which may include purchase incentives, cost guarantees, and other contractual obligations associated with aircraft acquisition contracts
- The complexity of financing utilized to purchase aircraft and whether the aircraft was financed under a lease or secured debt financing, including whether interest rates are at market and whether interest is variable or fixed
- Determining the classification of leases as capital or operating can be complex and subject to significant judgments and estimates
- Leasing structures involving trusts or other entities that have few or no operations other than leasing a specific asset or group of assets and the related evaluation of whether they are VIEs
- Continued losses that might indicate impairment exists on assets held for use
- The current economic environment of the airline industry and current industry trends with regard to discontinuing manufacturing of certain fleet types or new fleet types that affect the values of existing fleets and the related spare parts
- Fleet plans of other airlines (passenger and nonpassenger) that affect the fair values of aircraft and the related spare parts
- Delays and other changes to aircraft acquisition contracts and their effect on recoverability of certain fixed assets, including related capitalized interest
- The complexity and frequency of fleet plan changes

- The level of modifications being made to aircraft fleets
- Subjective interpretation of management plans for the disposition of aircraft when evaluating whether the aircraft meets the held-for-sale criteria
- The airline’s history associated with fleet retirements and accuracy of its estimates of obsolescence reserves
- Appropriateness of depreciable lives due to fleet plan modification or impairment assessment
- Whether aircraft maintenance is performed in-house or outsourced and the terms of outsourcing arrangements
- New agreements that provide for spare parts to be used by the airline
- The number of locations where parts are maintained

Exhibit 4-1

PBTH Contract Attributes and Risk Transfer Evaluation

Contract Attributes	*Contract A*	*Contract B*	*Contract C*	*Contract D*	*Contract E*
Term	Long term (>5 years)	10 year	10 year	10 year	6 year
Scope	Routine engine maintenance. Any unusual rework outside scope of contract	Routine engine maintenance. Any unusual rework outside scope of contract	Routine engine maintenance. Any unusual rework outside scope of contract	Routine engine maintenance. Any unusual rework outside scope of contract	Routine engine maintenance. Any unusual rework outside scope of contract
Up-front payment	Yes	No	No	No	Yes
Timing of payment	Monthly with various adjustments described below	Monthly based upon flight hours	At time of engine event based upon number of hours since last maintenance event	At time of engine event based upon number of hours since last maintenance event	Monthly based upon flight hours
Basis for charge (that is, amount per flight hour)	$X Year 1 $Y Year 2 $Z Year 3+ Per flight hour	$X Year 1 $Y Year 2 $Z Year 3+ Per flight hour	Fixed rate per flight hour, adjusted for inflation based upon materials price index	Fixed rate per flight hour adjusted for CPI	Fixed rate per flight hour adjusted for CPI, not less than 1.5 percent
Price escalation adjustment and how often	Yes—pursuant to formula in contract (CPI based) Calculated annually	Nonprogram work is at contractual labor rates that are subject to CPI—rate per hour does not change	Adjusted annually	Adjusted annually	Adjusted annually
Periodic true-up adjustments under the contract	Yes annually—based on changes in utilization versus estimates (that is, flight hours) and actual costs versus estimates	Yes annually—based upon number of qualifying engine events	None	None	None
Termination provision	None	Upon default by either party (as defined) or bankruptcy	Upon default by either party (as defined) or bankruptcy	Upon default by either party (as defined) or bankruptcy	Upon default by either party (as defined) or bankruptcy
Settlement at termination	None	None	None	None	Settlement based on actual costs of the service provided versus payments received under the contract
Risk transfer conclusion (Yes or No)	No	No	Yes	Yes	Possibly. See the following explanation.
Basis for risk transfer conclusion	Annual true-ups to actual costs incurred by the service provider do not result in risk transfer to the service provider.	Annual true-ups based on the number of actual engine events experienced is considered sufficiently different from the criteria used to make payments under the contract (that is, flight hours) such that the contract does not effectively transfer risk.	This contract provides for no true-up provisions (either annually or upon termination), and pricing terms are fixed such that a full risk transfer has occurred.	This contract provides for no true-up provisions (either annually or upon termination), and pricing terms are fixed such that a full risk transfer has occurred.	This contract provides for a true-up upon a default by either party to the contract. In this situation, the default provisions would need to be evaluated to determine if those provisions are substantive (for example, not effectively providing an exit opportunity for either party). If they are substantive, AcSEC believes risk transfer has occurred.

Exhibit 4-2

Example of PBTH Payment Term Model Applications

	Example A	***Example B***	***Example C***	***Example D***
Risk transfer	Yes	Yes	Yes	Yes
Term	6 years	6 years	6 years	6 years
Payments and related terms	$95 per flight hour in Years 1–3 $120 per flight hour in Years 4–6	$110 per flight hour, adjusted annually based on CPI	$100 per flight hour, adjusted annually based on 50% of the parts materials cost index	$95 per flight hour in Years 1–3 $120 per flight hour in Years 4–6
Fleet type	New	Mature	New	Mature
Expense recognition	Accrue expense as flight hours are incurred, based on rate in effect for the applicable contract period (that is, expense as incurred).	Accrue expense as flight hours are incurred, based on rate in effect for the applicable contract period (that is, expense as incurred).	Accrue expense as flight hours are incurred, based on rate in effect for the applicable contract period (that is, expense as incurred).	Recognize expense on a straight-line basis over the contract term.
Basis for conclusion	Although the contract does provide for fixed escalating rates per flight hour, the airline concluded that the anticipated annual payments are consistent with the level of service to be received on a new fleet that needs less maintenance in its first three years of service than in subsequent years. Therefore, expense is based on the periodic rates set forth in the PBTH contract.	The contractual rates are adjusted based on an index rather than a fixed amount or percentage.	The contractual rates are adjusted based on an index rather than a fixed amount or percentage.	The contract provides for fixed escalating rates per flight hour, and, because the related fleet is mature, the airline concluded that the annual payments are not necessarily consistent with the level of service to be received. Therefore, expense is recognized on a straight-line basis over the noncancelable contract term.

Exhibit 4-3A

PBTH Rate Calculation and Leveling Considerations

Scenario A—Base case expected for a PBTH contract with a four-year term.

	Year 1	***Year 2***	***Year 3***	***Year 4***	***Total***
Flight hours anticipated	2,500	2,700	3,000	2,200	10,400
Rate per hour applicable	$93.00	$98.00	$101.00	$120.00	$102.32
Anticipated payments	$232,500	$264,600	$303,000	$264,000	$1,064,100
Leveled expense (a)	$255,793	$276,257	$306,952	$225,098	$1,064,100
Difference	($23,293)	($11,657)	($3,952)	$38,902	–

(a) Determined based on the application of the anticipated overall contract rate (that is, total anticipated payments over the contract term divided by total anticipated flight hours—in this example $102.32) to flight hours for the period.

Exhibit 4-3B

PBTH Rate Calculation and Leveling Considerations

Scenario B—Base case expected for a PBTH contract with a 4-year term, adjusted based on the actual flight hours in Year 1, but no change in total hours anticipated over the contract term.

	Year 1	***Year 2***	***Year 3***	***Year 4***	***Total***
Flight hours anticipated	2,800	2,700	3,000	1,900	10,400
Rate per hour applicable	$93.00	$98.00	$101.00	$120.00	$101.54
Anticipated payments	$260,400	$264,600	$303,000	$228,000	$1,056,000
Leveled expense (b)	$286,488	$273,379	$303,755	$192,378	$1,056,000
Difference	($26,088)	($8,779)	($755)	$35,622	–

(b) Computed the same as the rate in Scenario A, except that the rate is adjusted after Year 1, based on the actual flight hours incurred in Year 1. In this calculation, Year 1 is calculated at the overall contract rate computed in Scenario A (that is, at the inception of the contract) multiplied by actual flight hours for Year 1. Then the Year 2 through Year 4 rate is recomputed by taking the total anticipated payments less Year 1 expense, divided by the remaining anticipated flight hours in Years 2 through 4.

Exhibit 4-3C

PBTH Rate Calculation and Leveling Considerations

Scenario C—Base case expected for a PBTH contract with a 4-year term, adjusted based on the actual hours in Year 1 and a change in total hours anticipated over the contract term.

	Year 1	***Year 2***	***Year 3***	***Year 4***	***Total***
Flight hours anticipated	2,800	2,700	3,000	2,500	11,000
Rate per hour applicable	$93.00	$98.00	$101.00	$120.00	$102.55
Anticipated payments	$260,400	$264,600	$303,000	$300,000	$1,128,000
Leveled expense (c)	$286,488	$277,083	$307,870	$256,558	$1,128,000
Difference	($26,088)	($12,483)	($4,870)	$43,442	–

(c) Computed the same as the rate in Scenario A, except that the rate is adjusted after Year 1, based on the actual flight hours incurred in Year 1 and the revised anticipated total flight hours over the contract term. In this calculation, Year 1 is calculated at the overall contract rate computed in Scenario A (that is, at the inception of the contract) multiplied by actual flight hours for Year 1. Then the Year 2 through Year 4 rate is recomputed by taking the revised total anticipated payments less Year 1 expense, divided by the revised remaining anticipated flight hours in Years 2 through 4.

Proposed AICPA Audit and Accounting Guide

Airlines

Chapter 5

Employee-Related Costs

General

5.01 Salaries, wages, and benefits are among airlines' most significant operating expenses. Almost all major airlines provide their employees with a variety of benefits, including defined benefit and defined contribution pension plans, other postretirement benefits (such as certain health care and life insurance benefits), and postemployment benefits. Certain of these benefits are discussed in detail in this chapter. Typically, low-cost airlines do not offer defined benefit plans or other postretirement benefits. The majority of airline employees belong to unions, and an airline frequently has a number of unions representing its various work groups.

Amendable Labor Contracts

Background

5.02 Labor contracts in the airline industry are covered under collective bargaining agreements (CBAs) that are governed by the Railway Labor Act of 1926. Under the provisions of the Railway Labor Act, CBAs do not expire but rather become amendable as of a stated date. Contract employees may not strike upon a contract becoming amendable but must continue to work under the terms of the existing CBA until certain actions have taken place. If either party wishes to modify the terms of the existing CBA, it must notify the other party in the manner described in the agreement. After receipt of such notice, the parties must meet for direct negotiations, and, if no agreement is reached, either party may request the National Mediation Board (NMB) to appoint a federal mediator to participate in the negotiations for a new or amended CBA. If no agreement is

reached in mediation, the NMB may determine, at any time, that an impasse exists and offer binding arbitration to the parties. Either party may decline to submit to arbitration. If arbitration is rejected by either party, a 30-day "cooling off" period begins. At the end of this 30-day period, the parties may engage in "self-help," unless the President of the United States appoints a Presidential Emergency Board (PEB) to investigate and report on the dispute. Self-help includes, among other things, a strike by the union, the imposition of proposed changes to the CBA by the airline, the hiring of new employees to replace any striking workers, or the outsourcing of job functions. However, if there is a strike, the President can order employees to return to work. The appointment of a PEB maintains the status quo for an additional 60 days. If the parties do not reach agreement during this period and no action is taken by the U.S. Congress (which can enact legislation that imposes a settlement on the parties), the parties may again engage in self-help.

5.03 In times of relative economic stability, CBAs generally include increases in wages and other benefit enhancements; in periods of economic downturn and increased competition, wage and benefit reductions and changes to work rules resulting in increased productivity have been more common.

5.04 Neither party is required to agree to modifications prior to the amendable date of a CBA unless stipulated in the agreement, although nothing prevents the parties from agreeing to start negotiations or to modify the CBA in advance of the amendable date. The contract negotiation process can be quite lengthy, and at times employees covered by a CBA have worked for a period of years beyond the amendable date under the existing CBA while the new CBA was being negotiated. Because of the significant delay, the new CBA may include provisions calling for retroactive wage payments to compensate employees for the period between the amendable date and the ratification date of the new contract. Many forms and types of pay, benefits, or both can be provided to compensate the employees for working during the amendable period. Retroactive pay is characterized by the fact that it is paid to employees for services provided during the amendable period.

Employees who terminate employment prior to the finalization of a new contract may still be eligible for retroactive pay.

Accounting Guidance

5.05 The guidance that follows applies to retroactive wage payments only. This section does not address other compensation and benefits, such as pensions, that should be accounted for in accordance with other applicable literature.

5.06 Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies,* provides guidance for determining when to recognize a liability for retroactive wage payments. FASB Statement No. 5 requires the accrual of a liability if (*a*) information available prior to issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements and (*b*) the amount of the liability can be reasonably estimated.

5.07 The underlying events causing the airline to consider recognizing a liability are (*a*) the CBA becoming amendable and (*b*) the continuation of employee service during the amendable period. For a liability to be recognized in the financial statements, these events must have occurred before the date of the financial statements.

5.08 In many cases, application of the model outlined in the following sections would result in the accrual of a liability at a point prior to contract ratification.

Probability That a Liability Has Been Incurred

5.09 The following are some of the factors that are integral to assessing whether it is probable that a liability for retroactive wages has been incurred:

- Prior history of the airline and the labor group with which it is negotiating (whether the airline has a demonstrated history of making or not making retroactive wage payments)

- Management’s intent to provide retroactive wages (whether management has obtained the board of directors’ approval to offer retroactive wages as part of the package)
- The existence of an offer of retroactive wages (whether an offer has been made that includes a provision for retroactive wages)
- Union group’s expectations (whether the union group expects retroactive wages to be a part of the final contract. This may be difficult to determine and, therefore, will be based on management’s reasonable belief and other evidence available to the airline such as management’s current interaction with the union group during the contract negotiation process)
- The terms of recent agreements reached by other airlines with similar union groups (recent completed agreements are frequently used as benchmarks for other agreements being negotiated)

Ability to Reasonably Estimate the Liability

5.10 Because the CBA negotiation process is fluid, with numerous proposals and counterproposals, it may be difficult to make reasonable estimates in the early stages of the negotiation process. Estimates developed in the early stages of the negotiation process in many cases later require significant revision. Further complicating the estimation process is the fact that airlines have multiple means of compensating employees, which could alleviate the need for retroactive wages. For example, an enhanced pension benefit might be provided in lieu of retroactive wages.

5.11 FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, concludes that the criterion for recognition of a loss contingency in paragraph 8(b) of FASB Statement No. 5—that "the amount of loss can be reasonably estimated"—is met if a range of loss can be reasonably estimated. For airlines, the range of an estimated retroactive wage liability will be defined and refined as events in the negotiation process occur.

5.12 Any change in the airline's estimate of retroactive wage liability should be based on reliable information, and the effect of the change should be accounted for by adjusting the accrual in the period of change in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections.* Disclosure is required if the effect of a change in the estimate is material to the interim or annual financial statements.

5.13 Following are two examples of the accounting for changes in estimates related to amendable labor contracts. These examples assume that Airline A has a history of paying retroactive wages and that management intends to offer retroactive wages as a component of the new CBA. Additionally, new CBAs at other airlines have continued the trend of increasing base wage rates, thus causing pilot wage rates at Airline A to fall below market. Based on these factors, management believes it is probable that retroactive wages will be paid and can be reasonably estimated.

5.14 *Increase in Estimate.* Airline A is negotiating a new CBA with its pilots. The existing CBA has an amendable date of June 30, 20X4. In the 12 months subsequent to June 30, 20X4 (the amendable date), pilot wages (based on the terms of the existing CBA) were $500,000,000. Airline A estimates an increase to pilot wages of 2.5 percent and believes it will take 2 years to negotiate and ratify a new CBA. Accordingly, Airline A accrued $12,500,000 for retroactive wages for the year ended June 30, 20X5. In July 20X5, Airline A concludes, based on a recent agreement reached by another airline and its pilots, that its best estimate of an increase in retroactive wages is 4.5 percent. As a result of the change in its estimated retroactive pay, Airline A increases its accrual for pilot retroactive wages by $10,000,000 for the 12-month period ended June 30, 20X5 (to a total of $22,500,000) in July 20X5, with a corresponding charge to salaries and benefits expense to reflect this change in estimate. If the financial statements for the quarter ended June 30 had not been issued by the time of the decision, this change would be accounted for in this quarter as a Type 1 subsequent event.[9] Airline A will also prospectively accrue $5,625,000 for the quarter ended September 30, 20X5 ($22,500,000 divided by 4).

9 AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), defines *Type 1 subsequent events* as those events that provide additional evidence with respect to conditions that existed at

5.15 *Decrease in Estimate.* Airline A is negotiating a new CBA with its pilots. The existing CBA has an amendable date of June 30, 20X4. In the 12 months subsequent to June 30, 20X4 (the amendable date), pilot wages (based on the terms of the existing CBA) were $500,000,000. Airline A estimates an increase to pilots wages of 2.5 percent and believes it will take 2 years to negotiate and ratify a new CBA. Accordingly, Airline A accrued $12,500,000 for retroactive wages for the year ended June 30, 20X5. In July 20X5, Airline A management decides, based on a new offer from its pilots, to eliminate the proposed retroactive wage increase of 2.5 percent in return for bonuses in future years if Airline A meets certain financial thresholds in those years. As a result of the elimination of the expected retroactive pay raise, in July 20X5 Airline A reverses its $12,500,000 accrual for pilot retroactive wages for the 12-month period ended June 30, 20X5 (with a corresponding credit to salaries and benefits expense to reflect this change in estimate), and discontinues further accrual of retroactive wage payments. If the financial statements for the quarter ended June 30 had not been issued by the time of the decision, this change would be accounted for in this quarter as a Type 1 subsequent event.[10]

Evaluation Points

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the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

AU section 560 defines *Type 2 subsequent events* as those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading.

The Financial Accounting Standards Board has a project on its agenda the objective of which is to establish general standards of accounting for and reporting of events that occur subsequent to the balance sheet date that would replace existing requirements that are currently contained in the auditing literature. A further objective of the project is to consider whether certain minor differences between U.S. generally accepted accounting principles and the corresponding international financial reporting standard, International Accounting Standard 10, *Events after the Balance Sheet Date,* could be eliminated or minimized.

10 See footnote 9 for the definitions of *Type 1* and *Type 2 subsequent events*.

5.16 Due to the fluid nature of negotiations between airlines and their various work groups, it is difficult to assess the probability of retroactive wages or to estimate a range of amounts of those wages. It would not be unusual for two airlines to reach different conclusions based on similar facts. However, in an effort to promote consistency, AcSEC has set out the following events in the CBA negotiation process. These events mark the points in the negotiation process at which the probability that a liability has been incurred and the extent to which any liability is reasonably estimable should be evaluated. The list of these events is arranged in ascending order; that is, the likelihood of accruing a liability increases toward the end of the list and is also higher when more than one of these conditions exist with respect to an airline. It is assumed that, at each of these points, the contract is amendable and the airline has a history of paying retroactive wages. Airlines should apply the guidance based on the facts and circumstances of the particular contract negotiation:

- Recently negotiated union contracts at other airlines during the amendable period of the contract in question with significant increases in wage rates may lead to requests for retroactive wages during the amendable period.
- Management begins negotiations with an expectation that retroactive wages will be a component of the future CBA.
- Substantive communication from management indicates that retroactive wage payments will be a part of the new CBA.
- Management has made an offer that includes retroactive wages.
- A tentative settlement is reached with union leadership, subject to union ratification, that includes retroactive wages.
- The board of directors approves the new CBA containing retroactive wages or, alternatively, a bankruptcy court approves the new CBA.

5.17 Once a CBA is ratified, the retroactive wage liability should be adjusted to reflect the estimated amount payable under the new CBA.

5.18 If an airline has no history of providing retroactive wages during periods when contracts are amendable, an accrual would be inappropriate absent strong evidence to the contrary (that retroactive wages will be part of the final contract).

Disclosures

5.19 See the "Risks and Uncertainties" section of Chapter 7 for disclosure considerations related to amendable labor contracts.

Pensions

Background

5.20 Pensions are a major cost for the many airlines and involve the application of complex accounting guidance. Most traditional airlines have a wide array of pension arrangements and typically provide benefits using a combination of defined benefit and defined contribution plans. Low-cost airlines generally provide benefits under defined contribution plans. Through years of labor negotiations, some airlines have provided pension benefit enhancements in lieu of current cash consideration. In addition, because of competition and the growth of low-cost airlines, many traditional airlines have terminated, frozen, or otherwise modified their defined benefit plans to reduce costs and conserve cash.

5.21 During periods of high interest rates, high asset valuations, and high market returns, the traditional airlines' pattern of enhancing retirement benefits kept cash compensation low and did not have a negative effect on the plans' funded status. However, in periods of low interest rates and below-average asset returns, substantial increases in pension obligations, underfunded pension plans, and increasing annual pension costs occurred, requiring an increased level of cash funding. These conditions have historically resulted in significant underfunding of the airline industry's defined benefit plans.

5.22 FASB Statements No. 87, *Employers' Accounting for Pensions,* No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits,* and No. 132(R) (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits,* as amended by FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans,* govern accounting for pensions.

Critical Assumptions

5.23 Critical assumptions used in the measurement of net periodic pension cost and the projected benefit obligation and determination of funded status are: the discount rate, expected long term rate of return, rate of compensation increase, expected rate of retirement, expected rate of turnover, recall rates of furloughed employees, and the mortality curve. FASB Statement No. 87 states that each significant assumption shall reflect the best estimate solely with respect to that individual assumption. Some of these assumptions are discussed in the following sections.

Discount Rate

5.24 According to paragraphs 44 and 44A of FASB Statement No. 87, an employer may look to rates of return on high quality fixed-income investments in determining assumed discount rates. Notionally, the discount rate would be an amount that would equate the projected benefit obligation to the current market value of a portfolio of high quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. However, in other than a zero coupon portfolio (such as a portfolio of long term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments), the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates shall be extrapolated from the existing yield curve at the measurement date. In Emerging Issues Task Force (EITF) Topic No. D-36, "Selection of Discount Rates Used

for Measuring Defined Benefit Pension Obligations and Obligations of Postretirement Benefit Plans Other Than Pensions," the Securities and Exchange Commission staff indicated that they believe fixed-income debt securities that receive one of the two highest ratings given by a recognized ratings agency may be considered high quality. Under this approach, the airline selects the discount rate based on benchmark indices, such as Moody's Aa corporate bond index, as the starting point for calculating its discount rate. However, when using this approach, an airline should focus on the quality of, and related company-specific support for and documentation of, the discount rate selected. Although benchmarking against industry peers can help an airline in assessing the reasonableness of its discount rate, benchmarking should not be the basis for selecting the discount rate (or any other assumption) because it does not take into account the variations in plan or participant characteristics. Documentation and support for the discount rate should not be limited to actuarial valuations or peer company comparisons but rather should be based on the company's specific facts and circumstances.

Expected Long Term Rate of Return

5.25 The expected long term rate of return should reflect long term earnings expectations on existing plan assets as well as those contributions expected to be made during the current year, and it should be consistent with the current asset mix in the portfolio. The expected long term rate of return is estimated based on many factors including, among other things, (*a*) the expected asset allocation, (*b*) assumed market volatility of the portfolio, (*c*) the plan's investment policy, (*d*) the method of constructing a best estimate range of investment returns, (*e*) historical returns by asset category, and (*f*) analysts' forecasts of market returns.

Airline-Specific Assumption Considerations

5.26 *Rate of Compensation Changes, Expected Rates of Retirement, and Turnover.* Although the effects on current year expense and the projected benefit obligation of a change in the expected rate of retirement, turnover rate, and rate of compensation increase are not as dramatic as those of a change in the discount rate and expected long

term rate of return, the airline and its auditors should ascertain that the expected rate of retirement, turnover rate, and rate of compensation increase are consistent with the airline's actual experience, plan design or CBA agreements, and future expectations in the industry.

5.27 During periods of economic uncertainty in an industry characterized by wage concessions and revised CBAs that keep future salary increases to a bare minimum, some airlines reduce the weighted-average rate of compensation to the current CBA rate of increase as the ultimate rate. However, if the current CBA provides for no salary increases, the airline should not use it as the ultimate rate. It is acceptable to assume that there will be no compensation increases for a certain number of years, but eventually the rate will have to increase in response to inflationary pressures.

5.28 *Furlough Return Rate.* Furloughs and layoffs are common in the airline industry during downturns in the economy. The furlough rate of return can be a significant factor in determining the appropriate accounting estimates to be used for pension accounting. Furloughs generally affect pension estimates because certain furloughed employees can continue to participate in defined benefit plans as long as they stand ready to return to work. An airline needs to accurately estimate not only the number of employees who will be recalled but also the effect of the recall on future service and other significant pension estimates.

Termination of Pension Plans

Accounting Guidance

5.29 An airline may terminate or make significant changes to its existing defined benefit plan. The guidance in FASB Statement No. 88 should be followed when evaluating terminations or other significant modifications to pension plans to determine if a curtailment, settlement, or both has occurred.

5.30 During periods of restructuring, there may be events in which a settlement, as defined in FASB Statement No. 88, has occurred. These events are associated with plan terminations or lump sum payouts driven by actions of the plan sponsor. FASB Statement No. 88 also provides guidance on accounting for small recurring settlements that may occur when lump sum payments are made to retirees. Such settlements may occur in periods of financial uncertainty at the airline when employees are taking early retirement or early retirement packages are being offered, which causes the amount of lump sum payouts to increase as compared with other years. If the cost of all settlements in a year is greater than the sum of the service cost and interest cost components of net periodic pension cost for the plan for the year, gain or loss recognition is required for those settlements.

Pension Benefit Guaranty Corporation

5.31 The Pension Benefit Guaranty Corporation (PBGC), a federal government agency established under Title IV of the Employee Retirement Security Act of 1974, administers the federal pension plan insurance program for defined benefit plans. The PBGC will be a major creditor of an airline in a bankruptcy proceeding if the airline sponsors an underfunded defined benefit plan. The PBGC may take over a defined benefit plan in the following situations: (*a*) standard termination, (*b*) distressed termination (bankruptcy situation or severe funding issues), and (*c*) involuntary termination (termination at the direction of the PBGC). With respect to pension plans turned over to the PBGC, settlement accounting is generally appropriate if the plan assets and obligation are transferred to the PBGC and if the plan takeover is irrevocable.

Other Postretirement Benefits

5.32 Certain airlines, especially traditional ones, offer other postretirement benefits, which generally consist of retiree medical benefits, bridge medical benefits (that provide coverage for retirees from the point of retirement to the age of 65 when they become eligible for Medicare), life insurance, and other benefits. Employees may make contributions toward funding a portion of these other postretirement benefits. Because

other postretirement benefits represent a significant cost for airlines due to rising healthcare costs, they are often the subject of negotiation during contract discussions.

5.33 FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* as amended by FASB Statement No. 158, provides guidance on accounting for other postretirement benefits. To the extent that the promise to provide postretirement benefits is similar to the promise to provide pension benefits, the accounting for such promises is similar to the accounting set forth in FASB Statements No. 87 and No. 88, which govern pension accounting. Accordingly, issues encountered when accounting for other postretirement benefits are similar to pension accounting issues. For example, when there is a change that decreases the benefits offered under other postretirement benefit plans, the airline needs to determine whether a negative plan amendment, curtailment, or settlement has occurred and the appropriate accounting for each event. Airlines need to distinguish between a negative plan amendment (which reduces benefits) and a curtailment (which eliminates the expected years of future service by active plan participants). Alternatively, when there is a change that increases other postretirement benefits and the change grants credit for prior service, the cost of the benefit improvement should be recognized as a charge to other comprehensive income at the date of the amendment. It is treated as prior service cost and amortized as a component of net periodic postretirement benefit cost over the remaining service period of the currently active employees who will receive the benefit. However, other postretirement benefits do not have the same funding requirements mandated by law as pensions.

5.34 Critical assumptions used in the determination of net periodic postretirement benefit cost, the accumulated postretirement benefit obligation, and funded status are the discount rate, expected long term rate of return, and the health care trend rate. The discount rate and expected long term rate of return on assets are determined in a manner that is consistent with the methodology described in the “Pensions” section of this chapter. The health care cost trend rate is an assumption about the annual rate(s) of change in the cost of health care benefits currently provided by the postretirement benefit

plan, due to factors other than changes in the composition of the plan population by age and dependency status, for each year from the measurement date until the end of the period in which benefits are expected to be paid. The health care cost trend rate implicitly considers estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of plan participants. Differing kinds of services, such as hospital care and dental care, may have different trend rates. The health care trend rate is generally determined by the airline with assistance from an actuary.

Other Key Employee Benefits

5.35 Other key benefits include, but are not limited to, workers' compensation (WC), salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including WC), job training and counseling, and continuation of benefits such as health care benefits and life insurance coverage. Benefits may be paid as a result of a disability, furlough or layoff, leave of absence, death, or other events. Following are brief descriptions of some of these key employee benefit obligations incurred by airlines and any unique attributes of those obligations.

Workers' Compensation

5.36 WC laws are designed to ensure that employees who are injured or disabled on the job are provided with fixed monetary awards, eliminating the need for litigation. These state laws also provide benefits for dependents of those workers who are killed because of work-related accidents or illnesses. Some laws also protect employers and fellow workers by limiting the amount an injured employee can recover from an employer and by eliminating the liability of co-workers in most accidents. State WC statutes establish this framework for most employment.

5.37 As in the manufacturing industry, the rate of WC incidents is high in the airline industry. As a result, many airlines incur substantial WC claim payments and record a large WC expense. Airlines frequently self-insure for some level of WC claims and maintain umbrella coverage over that amount. Airlines with significant self-funded plans

can have significant collateral deposit requirements to support the estimated claims anticipated under their WC plan. Sometimes, airlines use off-shore insurance companies to help minimize collateral requirements and provide certain tax benefits. The accounting for a fully self-insured or partially self-insured WC involves significant judgments and estimates by senior management. FASB Statement No. 5 and FASB Interpretation No. 14 provide guidance that should be followed when determining accruals for self-insured WC. Airlines should consider obtaining estimates from actuaries for significant WC accruals.

Severance Benefits

5.38 Severance or termination benefits may take various forms, including lump sum payments, periodic future payments, or both. They may be paid directly from an airline's assets, an existing pension plan, a new employee benefit plan, or a combination of those means. Which guidance is applicable to severance or termination benefits depends on the nature of the severance plan, as follows:

- FASB Statement No. 88 sets forth the accounting for special termination benefits offered for a short period or contractual termination benefits required by the terms of a plan if a specified event occurs.
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, sets forth the accounting for severance benefits paid under a contractual provision (typically for union employees) or pursuant to an established plan.
- FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities,* sets forth guidance on accounting for termination benefits provided to employees who are terminated involuntarily under the terms of a benefit arrangement that is not an ongoing benefit arrangement or an individual deferred compensation contract (for example, a one-time severance benefit).

5.39 FASB Statement No. 146 provides that, if employees are required to render service until they are terminated in order to receive termination benefits, the liability for the termination benefits shall be recognized ratably over the future service period. This

practice is common in the airline industry because an immediate reduction in work force would be disruptive to operations due to training issues associated with pilots and, to a lesser extent, flight attendants and mechanics. However, a special termination benefit offered to employees should be accounted for in the period the offer is accepted in accordance with FASB Statement No. 88. Based on guidance in FASB Statement No. 112, a severance benefit paid in accordance with union contract provisions should be accounted for in accordance with FASB Statement No. 43, *Accounting for Compensated Absences*, if the obligation is attributable to employees' services already rendered, employees' rights to those benefits accumulate or vest, payment of the benefits is probable, and the amount of the benefits can be reasonably estimated. If those 4 conditions are not met, the employer should account for severance benefits in accordance with FASB Statement No. 5, in the period in which (*a*) based on information available prior to issuance of the financial statements, it is probable that a liability has been incurred at the date of the financial statements and (*b*) the amount of the liability can be reasonably estimated. Therefore, a thorough understanding of the severance benefit offered is required to determine the appropriate accounting.

Pilot Disability (Permanently or Medically Grounded)

5.40 Grounding of a pilot can occur for medical reasons such as poor eyesight, physical disabilities, or heart conditions. Most pilots' CBA contracts call for a salary continuation benefit that is based on a percentage of the pilot's average earnings over a specified period. Disability benefits are generally accounted for in accordance with FASB Statement No. 112.

Voluntary Furloughs

5.41 Certain work group contracts have provisions that permit employees to accept voluntary furloughs in lieu of furloughing other employees who would generally be furloughed on a seniority basis. Airlines accept the voluntary furlough programs because they generally result in furloughing slightly higher compensated employees than would be furloughed in the event of a seniority-based furlough. As an incentive to accept the

voluntary furloughs, employees typically receive medical, dental, and certain other benefit coverages during the furlough period. The cost of these benefits should generally be accrued when the voluntary furlough is accepted. In addition, the effect of these furloughs on accounting estimates for pensions and other postemployment benefits should be considered.

Flight Crew Payroll

5.42 The pay of flight personnel (pilots and flight attendants) normally represents the largest portion of an airline's salaries expense. The pay is usually determined collectively based on the rates specified in the CBA and generally depends on a number of variables including, among others, number of hours flown, the type of equipment flown, whether the hours flown were day or night hours, seniority, and flying status (for example, pilot, first officer, flight engineer, or flight attendant). Crew members are also reimbursed a daily per diem for each day away from their assigned home base.

Inherent Risk Factors

5.43 Significant inherent risks that should be considered by the auditor in the compensation and benefit areas might include the following:

- Subjectivity in judgments and estimates associated with amendable labor contracts
- Lengthy period during which a contract is amendable
- Significant management judgment and estimates related to the actuarial process to calculate pension, postretirement, postemployment, and self-insured WC expense
- Economic downturns that might result in the airline making significant changes to its benefit plan offerings (conversion of a defined benefit plan)
- Changes and enhancements to employee benefits
- Effect on benefits for a financially distressed airline (for example, reductions in force)
- Changes in broad economic assumptions

Proposed AICPA Audit and Accounting Guide

Airlines

Chapter 6

Other Accounting Considerations[11]

Intangible Assets

6.01 Intangible assets, either acquired or developed internally, may consist of the following: international route authorities (routes), airport landing and take-off rights (slots), airport operating rights, frequent flyer agreements, customer base, international alliance agreements, code-share agreements, trade names, and vendor contracts. When airport gates are purchased in a transaction that is not part of a business combination, the value of the gates is usually recorded separately. However, when acquired as part of a business combination, gates would generally be valued as a component of airport operating rights except to the extent that the underlying lease qualifies as a contractual intangible (that is, a favorable lease).

6.02 Currently, the unique intangible assets in the airline industry are primarily domestic slots, airport operating rights, and international routes and slots.

11 This chapter contains numerous references to fair value. It does not, however, reflect the requirements of Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*, which provides enhanced guidance for using fair value to measure assets and liabilities. FASB Statement No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. This guide will be updated at a future date to reflect changes arising from FASB Statement No. 157.

Domestic Assets

Domestic Slots

6.03 In 1968, the Federal Aviation Administration (FAA) introduced the High Density Traffic Airports rule that established a fixed number of take-off and landing rights at certain very high density airports (including New York John F. Kennedy International, New York LaGuardia, Washington Reagan National, and Chicago O'Hare) to avoid excessive congestion and to reduce delays. These slots were initially granted to the incumbent airlines, but they can be leased, traded, or sold on an individual or overall basis at each airport. In March 2000, the Wendell H. Ford Aviation Investment and Reform Act was passed, resulting in the elimination of slot restrictions at O'Hare on July 1, 2002, and at LaGuardia and Kennedy on January 1, 2007. The legislation does not provide for elimination of slots at Reagan airport. However, the FAA has since issued orders to impose new operating restrictions at LaGuardia and O'Hare. In 2006, the FAA issued an order requiring carriers to hold arrival authorizations to land during certain hours at O'Hare. At LaGuardia, the FAA has proposed interim rules that would impose caps and restrictions on flight operations similar to O'Hare. The interim rules took effect in January 2007. The FAA has also proposed a longer term rule at LaGuardia designed to control air traffic congestion indefinitely. As regulations in this area continue to evolve, carriers need to carefully evaluate their effect on accounting for slots.

Airport Operating Rights

6.04 Airport operating rights represent the value of a carrier's established operations at airports that have certain attributes. Generally, this intangible asset exists at airports that have some or all of the following characteristics: significant barriers to entry exist at the airport, the airport is capacity constrained, or an airline has a substantial portion of the airport's capacity. An example would be an airline's operations at either its hub location or at a high density, capacity-constrained airport that is not slot controlled. Separately identifiable slot intangible assets and certain gate lease valuation intangibles would be recorded as separate intangibles and not as a component of airport operating rights.

6.05 Airport operating rights should be recognized as a freestanding intangible apart from goodwill when the asset arises from contractual or other legal rights or if it is separable from the airline as discussed in paragraph 39 of Financial Accounting Standards Board (FASB) Statement No. 141, *Business Combinations*. Generally, airport operating rights meet the separability criterion specified in FASB Statement No. 141 because the airline's underlying operations at the airport can be sold or leased in a separate transaction.

6.06 Airport operating rights may be developed internally by the airline through expansion of its operations at an airport, or they may be acquired individually or in a business combination. The fair value of airport operating rights is driven by market conditions, locations, and other factors and is generally determined using an income valuation approach.

Accounting Treatment

6.07 *Valuation.* An airline may have received the bulk of its slots at any given airport through its historical operations, by acquiring them (either from another airline or through a business combination), or by recognizing them through the application of fresh start accounting under Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* (AICPA, *Technical Practice Aids*, ACC sec. 10,460), which is discussed in the "Bankruptcy Matters" section of this chapter.

6.08 Consistent with paragraph 10 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, the cost of internally developed airport operating rights should be expensed as incurred.

6.09 Domestic slots and airport operating rights that were acquired (either from another airline or through business combinations) or recognized through the application of fresh start accounting should be capitalized and amortized over their useful life. Slots

and airport operating rights acquired in an asset purchase or business combination are recognized at their fair value as required by FASB Statement No. 141.

6.10 Airlines occasionally acquire domestic slots and airport operating rights through an exchange with other airlines involving either similar assets or similar assets and cash. These exchanges should be accounted for in accordance with FASB Statement No. 153, *Exchanges of Nonmonetary Assets*. Nonmonetary exchanges are generally recorded at fair value unless the exchange lacks commercial substance. The airline should evaluate the exchange to determine if the airline's future cash flows are expected to change significantly as a result of the exchange. If the exchange lacks commercial substance, the intangibles received are recognized at the recorded amount of the relinquished assets.

6.11 Domestic slots and airport operating rights have been traditionally considered to be finite-lived assets based on their close association to the related airport infrastructure, including leases and other operating or use agreements, and how these assets are expected to contribute directly or indirectly to future cash flows in accordance with the guidance in FASB Statement No. 142. The following factors should be considered in determining the useful life of these assets:

- The accelerated pace of change in the airline industry and the effects of competition among airports
- Legislative action that results in an uncertain regulatory environment as it relates to slots and their expected termination date
- The terms of existing facility leases at airports and reasonably assured renewal periods
- Statutory lives, if any, for slots

6.12 In certain cases, airlines may assign lives longer than those specified in the lease or other statutory or contractual provisions. In these cases, airlines have concluded that significant continuing value exists at these locations (due to significant capacity constraints at the airport, barriers to entry, or the airline's having a substantial portion of the airport's capacity), which would compel them to remain at the location past

contractual periods. See the "Amortization of Leasehold Improvements" section in Chapter 4 for a discussion of criteria that are applied in determining the lives of leasehold improvements. These criteria would also be considered in determining useful lives of intangible assets related to airport operations.

6.13 *Impairment.* Finite-lived intangible assets are assessed for impairment using the undiscounted cash flow methodology in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. FASB Statement No. 144 provides that a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Identifying the group of assets at which cash flows are largely independent requires judgment. For example, an airline might conclude that the airport to which the asset relates provides the lowest level of identifiable cash flows. Alternatively, an airline also might conclude that the airport to which the asset relates would not provide the lowest level of identifiable cash flows. This is because the cash flows from airport operating rights are largely dependent on cash flows from airline operations (that is, transportation of passengers), and using the cash flows at the airport level would involve a high degree of allocation. Therefore, for impairment testing purposes, airport operating rights would be a part of a larger asset group and would be evaluated at a higher level than the airport.

Gates

6.14 A gate is recorded as a separate asset if the right to use the gate is acquired from another airline. The value of the gate is determined based on the fair value of the consideration given to obtain the right to use the gate, that is, the amount paid or the fair value of the asset exchanged. The fair value of the gate lease also needs to be considered because if there is a difference between the recorded value of the gate and the fair value of the lease, it may indicate the existence of another asset. The value of gates does not include any leasehold improvements. The life assigned to the gate is the remaining term of the lease or the sublease from the other airline. As described in the "Amortization of Leasehold Improvements" section of Chapter 4, in limited circumstances the airline may

conclude that the useful life of leasehold improvements is longer than the contractually stated lease term for the related airport facility. When airport gates are acquired as part of a business combination, gates would generally be valued as a component of airport operating rights except to the extent that the underlying lease qualifies as a contractual intangible (that is, a favorable lease).

International Route Authorities and Slots

6.15 Access to foreign markets by U.S. registered carriers has historically been subject to bilateral agreements between the U.S. government and governments of foreign countries. These agreements can restrict access to U.S. gateway cities and foreign destinations by limiting the number of airlines that may provide service to certain airports, restrict service to certain airports, restrict types of aircraft, limit frequencies of flights, or limit the beyond flying capabilities of the carrier. These bilateral agreements provide that the route certificates are awarded by the U.S. government to the individual carriers on a temporary basis and that they can be renewed upon expiration by the Department of Transportation (DOT).

6.16 Administratively, the route certificate is considered a license for continuing activity and is renewed by the incumbent carrier based on the filing of a timely application combined with meeting a certain level of service. If a carrier files timely for renewal of its route authority and the DOT takes no action, the carrier's authority is extended by the applicable provisions of the law. DOT regulations include an affirmative rebuttable presumption standard in favor of renewal of the incumbent carrier's route certificate upon expiration of the certificate, and applications for renewal of route certificates by the incumbent carriers have been approved in virtually all cases. The cost to renew existing route authorities is nominal, and renewal does not contain material modifications of the existing terms.

6.17 Traditionally, foreign countries limited the access to routes from the United States to only a single or a few U.S. carriers and also frequently limited the destinations within

the United States that could be operated. That was done initially to protect the foreign countries' national carriers from competition. The more restrictive the access to a country or region (that is, the rights to fly to a country with beyond rights into other countries), the more valuable the route authority is to the carrier. In the 1980s and 1990s, as international travel boomed, distressed carriers sold their route authorities into various countries, either individually or in the aggregate. Because new authorities would rarely be granted, a carrier that wanted to start operations to a new country had no choice but to acquire the route authority from another carrier.

6.18 Route authorities traditionally have also designated the airport to which the airline may operate. Just as the value in a route authority is driven by restrictive access to a particular country or region, a significant amount of value can be derived from access to a restricted airport. Practice to date has viewed the right to fly between two countries (route authority) and the right to land at the international airport at a specific time (slot) as one asset or one asset group because the route authority and the slots are interdependent. In certain countries, however, slots are separable from the underlying route authority. The treatment of international slots varies based on the country or region in which the airport is located. For instance, slots do not formally exist in Latin America. An airline having appropriate operating authority pursuant to a bilateral agreement notifies the airport of its intent to operate the route and then works with the airport authority to determine an acceptable landing time. In addition, there is no history or experience of airlines being able to swap or trade these slot times independent of the related route authority. Therefore, these slots were simply considered to be either a specific component of the route authority or a procedural agreement with the airport that had no independent value. In the United Kingdom (UK) and other European Union (EU) member countries, slots are generally separable from the route authority and are administered by an independent coordinator at each airport. This practice developed over the years as the demand for slot times at high density airports increased. In the UK, a market exists for the transfer or monetization of slots while in the rest of the EU member countries, monetization of the slots is not permitted. Slots in the EU can be transferred but for no value, except that they generally can be transferred along with other assets. In

Japan and China, slots are separable assets but cannot be transferred apart from the route authority. Although slots are not transferable in Japan, carriers operating under the same bilateral treaty can use each other's slots (for example, under the U.S.-Japan bilateral agreement, United Airlines may use a Federal Express slot, but United Airlines and British Airways could not use each other's slots). Slots do not require renewal, although they are subject to a "use or lose" test, and the airlines have legal title to the slots.

Open Skies

6.19 Since the 1990s, the U.S. government has pursued a policy of "open skies" under which it has negotiated a number of bilateral agreements allowing unrestricted access to foreign markets. Historically, the markets in certain countries (most notably, Heathrow and Gatwick in the UK and Japan and China) have remained subject to restrictive bilateral agreements. Recently, the United States and EU signed an open skies agreement. Under the terms of this agreement, any European carrier will be allowed to fly to any city in the United States, and U.S. carriers will be granted access to all airports in the 27-nation EU. The agreement will become effective on March 30, 2008. Until that time, markets in certain EU countries (including Heathrow and Gatwick airports in the UK) will remain subject to restrictive bilateral agreements. It should be noted that even in an open skies country, a carrier must still acquire a route certificate and related airport access to operate to a specific destination within that country.

Effect of Open Skies on the Existence of an Asset

6.20 The AICPA Accounting Standards Executive Committee (AcSEC) believes that the effect of an open skies agreement on international routes and slots will depend on the nature of the recorded asset prior to the advent of the open skies environment, that is, whether an airline recorded routes and slots as separate assets or combined them as a single asset. Over the years, airlines have typically acquired or recorded asset values for routes and related slots in different types of transactions which can be described as follows:

- *Acquisition of a combined asset.* In periods prior to open skies, airlines typically acquired routes and related slots as part of a combined asset and recorded the acquired assets as one asset, generally referred to as a route authority. In most of these cases, the slot was not viewed as a separate asset, either at the time of the acquisition or upon the adoption of FASB Statement Nos. 141 and 142.
- *Acquisition of individual assets.* Occasionally, airlines acquired slots without routes and, on a much more limited basis, routes without the related slots in separate transactions and recorded them as separate assets.
- *Business combination or application of fresh start reporting.* In a business combination or as a result of the application of fresh start reporting, an airline either recorded routes and slots as individual assets or as a combined asset for a particular country or airport location within a country.

6.21 Upon adoption of FASB Statement No. 142, most recorded international intangible assets represented the combined assets (routes and slots) and were generally considered indefinite-lived intangible assets.

6.22 Ratification of open skies agreements will have a significant effect on routes and slots. Potentially, a route after open skies will have little or no value due to the elimination of substantially all restrictions on acquiring that asset, and a slot in a capacity controlled environment will contain substantially all of the value because it will represent the right that restricts access to the airport or country location. As indicated previously, the accounting after open skies will depend on whether in the original transaction an airline recorded routes and slots as separate assets or combined them as a single asset and can be summarized as follows:

- *Combined asset.* If a route and related slot were recorded as a single combined asset in the initial transaction, AcSEC believes that the combined asset still exists and would be subject to impairment testing based on the combined value of the route and slot. Although the route itself may have little or no value after the advent of open skies, an impairment may not exist because the value derived from

the slot restrictions may be sufficient to recover the combined intangible asset. See the "Impairment" section that follows for further discussion regarding impairment testing.

- *Individual assets.* There are two views on whether individually recorded routes will continue to meet the definition of an asset after open skies. Some AcSEC members believe that such routes will no longer meet the definition of an asset because open skies agreements will eliminate restrictions on the number of airlines that can be granted a route. Accordingly, these AcSEC members believe that the value associated with such routes should be charged to expense and the related slots should be evaluated for impairment. The alternative view is that such separately recorded routes will continue to meet the definition of an asset in an open skies environment. Under this view, separately recorded routes and slots would need to be tested for impairment based on the guidance in FASB Statement No. 142 and Emerging Issues Task Force (EITF) Issue No. 02-7, "Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets," as discussed in the "Impairment" section of this chapter.
- *Business combination or application of fresh start reporting.* For assets that were recorded as part of a business combination or as a result of the application of fresh start accounting, the accounting after open skies will be based on whether these assets were recorded as individual or combined assets as discussed in the two other examples in this list.

Useful Life

6.23 The discussion in this section pertaining to separately recorded routes assumes that the airline has concluded that the asset continues to exist after open skies. Airlines that believe that separately recorded routes no longer meet the definition of an asset in an open skies environment would write off this asset and, therefore, would not need to reassess its useful life. These airlines, however, would still evaluate useful life of separately recorded slots and combined assets as discussed in the following paragraphs.

6.24 Prior to an open skies environment, combined assets, separately recorded routes, and separately recorded slots in countries with restrictive bilateral agreements generally have been assigned an indefinite life. According to paragraph 16 of FASB Statement No. 142, an entity should evaluate the remaining useful life of an intangible asset that was determined to have an indefinite useful life each reporting period to determine whether events and circumstances continue to support an indefinite useful life. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset shall be tested for impairment in accordance with paragraph 17 of FASB Statement No. 142, as discussed in the "Impairment" section of this chapter.

6.25 In determining whether its international intangible assets should have a finite or indefinite life, the airline should follow the guidance in paragraph 11 of FASB Statement No. 142, which indicates that "the useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity." It also states that "if no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite."

6.26 In determining whether a separately recorded international route, slot, or combined asset has an indefinite or finite useful life, airlines need to consider and evaluate in particular the following factors described in paragraph 11 of FASB Statement No. 142:

- The expected use of the asset
- Any legal, regulatory, or contractual provisions that limit the asset's useful life
- Any legal, regulatory, or contractual provisions that enable renewal or extension of the asset's life without substantial cost
- The effects of obsolescence, demand, competition, and other economic factors

6.27 In addressing whether any legal or regulatory provisions may limit the useful life of a separately recorded route or slot or a combined asset, specifically with regard to the movement toward open skies, AcSEC believes the effect of open skies should be

analyzed on a country-by-country basis. There are two views on whether the possibility of this regulatory change should affect the indefinite-lived status of these assets. Some AcSEC members believe that airlines should not anticipate ratification of open skies in the future and would not consider it as a factor when evaluating the remaining useful life of these assets until open skies access is granted in the country to which the international route authority asset pertains**.** Other AcSEC members believe that airlines should take into account all relevant factors and consider the likelihood of this regulatory change and its effect on the indefinite-lived status of separately recorded routes, slots, and combined assets before the actual ratification.

6.28 Under FASB Statement No. 142, prior to an open skies environment, the useful life of combined assets, separately recorded routes, and separately recorded slots in countries with restrictive bilateral agreements generally has been considered indefinite. Specifically, Example 6 in Appendix A indicates that international route authorities are indefinite-lived intangible assets. AcSEC generally believes that once an open skies agreement is effective, even though the cash flows may continue indefinitely, they will do so at a diminished level, thus, potentially resulting in an impairment and a reassessment of the useful life of these assets. Each particular situation should be evaluated based on its facts and circumstances; however, AcSEC believes that after the ratification of open skies, international intangible assets may be more appropriately considered to be finite-lived assets.

6.29 Slot transition provisions (which may allocate slots to new airport entrants), existing and future terminal capacity at the airport, future runway construction, and the airline's operating intention with respect to the airport where the slots are located influence the airline's reconsideration of the useful life. Absent slot transition provisions, an airline may be able to support the indefinite-life status of separately recorded international slots and combined assets.

6.30 When evaluating the useful lives of its international intangible assets, an airline also needs to consider the lives of related asset groups or individual assets that support these assets, such as airport leases, airport infrastructure, and related aircraft.

Impairment

6.31 Paragraph 17 of FASB Statement No. 142 requires that an intangible asset that was determined to have an indefinite useful life and is not subject to amortization be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Indefinite-lived intangible assets, including those that are subsequently determined to have a finite useful life, are assessed for impairment using the fair value methodology described in paragraph 17 of FASB Statement No. 142. Airlines should consider EITF Issue No. 02-7, which provides guidance on what the unit of accounting should be for purposes of testing indefinite-lived intangible assets for impairment pursuant to paragraph 17 of FASB Statement No. 142.

6.32 When testing separately recorded international routes and slots for impairment and applying EITF Issue No. 02-7, an airline will need to determine whether these assets should be treated as a single unit of accounting or evaluated separately. Based on the analysis of indicators in EITF Issue No. 02-7, the following factors would support treating routes and slots as a single unit of accounting for impairment testing purposes:

- International route authorities were either issued to or acquired by airlines as one asset (the slots were a component of the route authority), or the route and slots were acquired separately but subsequently used together prior to the advent of open skies.
- The route at an airport has little or no value without the slots, and vice versa.
- The requirement to have both assets (route and slots) at a specific location in order to operate the flight.
- The route and slots have traditionally been sold together.
- Integration of cash flows from routes within a region, that is, the need to fly to a specific city in order to operate fifth freedom rights from that city.

6.33 However, the following factors would support *not* treating routes and slots as a single unit of accounting for impairment testing purposes:

- Recently, route authorities to certain locations have been sold independently of slots and slots have been sold or leased independently of the related routes.
- Open skies might limit the useful economic life of routes but would not similarly limit the useful economic life of slots.

6.34 In applying EITF Issue No. 02-7 to routes and slots that were acquired separately, the airline should consider that separate acquisition of these assets implies the existence of a market for the individual assets in that particular location and that these assets may potentially need to be evaluated for impairment separately under the provisions of EITF Issue No. 02-7. Airlines that have adopted the view that after open skies individually recorded routes will no longer meet the definition of an asset would charge the value associated with such routes to expense instead of testing them for impairment and would evaluate the related slots for impairment. The following examples illustrate the application of EITF Issue No. 02-7 to situations in which routes and slots were acquired in separate transactions and recorded as individual assets:

- *Route and slots that were acquired in separate transactions but subsequently used as a combined asset prior to the advent of open skies.* In these situations, generally the combined asset, and not the individual components, would be evaluated for impairment.
- *A route that was acquired in a separate transaction and not used with a slot (generally this would occur only when an airport has no slot time restriction).* In this example, application of EITF Issue No. 02-7 would generally result in the route asset being evaluated for impairment on an individual basis. AcSEC believes that in an open skies environment, the individual route would likely be fully impaired in this situation because routes can now be obtained at little or no cost, and, as a result, their fair value is either zero or minimal.

- *Route and slots that were acquired in separate transactions and that have different useful lives.* In an open skies environment, an airline may conclude that the route is a finite-lived asset while the slot is still an indefinite-lived asset as discussed in the "Useful Life" section of this chapter. Based on the guidance in EITF Issue No. 02-7, different useful lives would preclude these assets from being evaluated for impairment on a combined basis. As a result, the route and the slot would be evaluated for impairment on an individual basis.

6.35 The preceding examples are not intended to cover all possible scenarios and outcomes. Accordingly, specific facts and circumstances need to be evaluated carefully to ensure that FASB Statement No. 142 and EITF Issue No. 02-7 are applied properly.

6.36 *Finite-Lived International Intangible Assets.* International intangible assets with finite useful lives should be tested for impairment in accordance with FASB Statement No. 144, as discussed in the "Accounting Treatment" section of the "Domestic Assets" part of this chapter. Also, if there are indications that a finite-lived intangible asset may be impaired, the airline may also need to reassess the useful life of the asset.

Inherent Risks

6.37 Inherent risks include the following:

- Changes in bilateral agreements and their effects on route valuations
- Frequent changes in the airline routes, pricing structures, or operations
- Recent changes in the regulatory environment at domestic airports
- The financial difficulties of the airline industry
- The complexity of determining the fair value of intangible assets for purchase price allocation and impairment purposes

Bankruptcy Matters

6.38 Over the years, a significant number of airlines have been forced to seek protection under Chapter 11 of the United States Bankruptcy Code to continue operations or have completed structured reorganizations to avoid a bankruptcy filing.

6.39 Readers should refer to SOP 90-7 for definitive guidance on accounting while in bankruptcy. A description of the application of that guidance in the airline industry follows.

Statement of Operations

6.40 The major change to an airline's statement of operations upon filing for reorganization under Chapter 11 of the bankruptcy code is the addition of a line item or a section titled "Reorganization Items," which includes revenues, expenses (including professional fees), realized gains and losses, and provisions for losses resulting from the reorganization and restructuring of the business. If reorganization items are presented as a single line item, the airline needs to disclose the components in the notes to its financial statements. Although SOP 90-7 is unclear as to whether the reorganization items should be presented in the "nonoperating" or "operating" section of the statement of operations, nonoperating has traditionally been the most common classification in the airline industry. Reorganization items may include the following:

- Estimated allowed claims for aircraft rejections
- Gains and losses on forgiveness of debt and allowed claims
- Rejection of special facility bonds
- Professional fees

6.41 One aspect of bankruptcies in the airline industry is Section 1110, which allows an automatic stay of 60 days with respect to paying interest or rent on qualifying aircraft. The debtor may extend the 60-day period through agreements with creditors and approval of the bankruptcy court. During this period, the debtor may decide to perform fully under

the lease or debt obligations, may negotiate with creditors for more favorable terms, or may ultimately decide to reject and return the aircraft to the creditor.

6.42 Before secured debt obligations related to Section 1110 aircraft are confirmed (that is, approved by the court as part of a plan of reorganization under a Chapter 11 proceeding, which makes it binding on the debtors and creditors), current practice is to accrue interest expense at the contractual rates in effect prior to the bankruptcy filing until the airline has resolved uncertainties regarding which debt obligations will be rejected or accepted and which debt obligations are either fully collateralized or undersecured. Paragraph 29 of SOP 90-7 provides that interest expense should be reported only to the extent that it will be paid during the proceeding or that it is probable that it will be an allowed claim. Therefore, if at a certain point the airline concludes that it is not probable that interest will be an allowed claim, the accrued interest liability may be adjusted to the expected amount of the allowed claims in accordance with FASB Statement No. 5, *Accounting for Contingencies*.

6.43 Under SOP 90-7, leases are considered executory contracts, and obligations related to leases prior to filing for bankruptcy are considered prepetition liabilities. For aircraft rent obligations, the debtor should continue to accrue aircraft rent expense until a determination is made that the aircraft will be rejected. Claims resulting from the rejection of a lease, such as rent obligations covering the stay period, are considered prepetition liabilities and are discussed in the "Rejected Aircraft" section that follows. SOP 90-7 provides that prepetition liabilities should be reported on the basis of the expected amount to be allowed by the bankruptcy court in accordance with FASB Statement No. 5, as opposed to the amounts for which those allowed claims may be settled. FASB Statement No. 5 provides that a liability should be recognized when a loss contingency is both probable and reasonably estimable.

Rejected Aircraft

6.44 Claims related to aircraft lease rejections are considered prepetition liabilities and should be reported at the estimated amounts of the allowed claims once the claims are probable and reasonably estimable, which would generally be when the aircraft rejection is approved by the bankruptcy court. The claims are recognized in reorganization expense. When leased aircraft are rejected, any leasehold improvements, deferred gains on sale-leaseback transactions, and maintenance or other deposits forfeited are written off as reorganization expenses. If aircraft pledged as collateral on debt arrangements are rejected in accordance with the provisions of the bankruptcy code, no gain or loss associated with the extinguishment of indebtedness should be recognized until the debtor is legally released from its obligation, which happens upon approval of the rejection by the bankruptcy court.

Balance Sheet

6.45 SOP 90-7 provides specific guidance for the preparation of the balance sheet during the reorganization period. Liabilities subject to compromise (which include all prepetition liabilities, or claims, except those that will not be impaired under the plan, such as claims that are fully secured) should be separated from those that are not and from postpetition liabilities (which are incurred subsequent to the filing of a petition and are not associated with prebankruptcy events). Liabilities incurred during the 60-day stay period are generally considered prepetition liabilities or administrative claims.

6.46 In an airline’s financial statements, liabilities subject to compromise are presented between current and noncurrent liabilities. The following are examples of liabilities generally not covered by first-day orders (various emergency or expedited motions and orders that are filed on or shortly after the filing of the Chapter 11 petition, the purpose of which is to deal with administrative matters and to ensure that the debtor's business and operations are stabilized and conducted in a manner consistent with past practice and the proposed plan of reorganization, pending consideration of confirmation of that plan) that would be reclassified into liabilities subject to compromise:

- Unsecured debt
- Undercollateralized debt
- Certain litigation and environmental claims
- Accounts payable
- Accrued rent
- Accrued interest
- Deferred gains and credits related to sale and leaseback of aircraft
- Dividends payable
- Manufacturer's credits

6.47 The following liabilities are typically affirmed by the airline as part of first-day orders and are not included in liabilities subject to compromise:

- Unearned revenue
- Frequent flyer liabilities
- Accrued wages and benefits, including vacation accrual
- Tax withholdings
- Foreign payables

6.48 In addition, the ultimate disposition of any amounts of intercompany debt or receivables in stand-alone subsidiary financial statements will need to be addressed based on the court's rulings with regard to the validity of such arrangements. Display of such items in the balance sheet during reorganization should consider the substance of the arrangements, classification in the financial statements prior to entering bankruptcy (for example, asset versus contra equity), and the status of the claim. Footnote 1 of Accounting Principles Board (APB) Opinion No. 26, *Early Extinguishment of Debt*, indicates that "extinguishing transactions between related entities may be in essence capital transactions."

Fresh Start Accounting and Reporting

6.49 Once a plan of reorganization has been approved by the bankruptcy court and the debtor is ready to emerge from under the protection of bankruptcy, the debtor needs to determine if fresh start accounting is appropriate. Traditionally, airlines have been required to apply a fresh start reporting model because they meet both of the conditions for fresh start reporting specified in SOP 90-7: (*a*) the reorganization value of the assets of the airline immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims and (*b*) holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the successor airline. SOP 90-7 provides requirements that should be followed by the debtor for the reporting of assets and liabilities. Fresh start accounting has the following implications:

- *Assets.* Reorganization value of the assets would be determined based upon the purchase method of accounting for business combinations prescribed in FASB Statement No. 141. Airline-specific fair value considerations include (*a*) routes, slots, and airport operating rights and (*b*) other intangibles.
- *Liabilities.* Liabilities that survive the reorganization should be recorded at fair value. Basically, the same rules outlined in FASB Statement No. 141 should be followed to determine the fair value of liabilities. Airline-specific fair value considerations include (*a*) air traffic liability and (*b*) frequent flyer liabilities.

6.50 The effects of the previously listed fresh start adjustments on the reported amounts of individual assets and liabilities and the effects of the debt extinguishment resulting from the adoption of fresh start accounting are recorded in the predecessor airline's statement of operations (that is, prior to emergence from bankruptcy). The adoption of fresh start accounting results in the adjustment of stockholders' equity based upon the reorganization value of the airline.

Inherent Risks

6.51 Inherent risks include the following:

- The complexity of airline bankruptcies
- The unique nature of certain assets and liabilities that require fair value calculations for fresh start accounting
- The volume of aircraft financing transactions
- The judgment required in determining expense classification (reorganization or operating)
- The unique nature of certain airline obligations

Guarantees and Indemnities

6.52 FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, addresses the accounting and disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees. FASB Interpretation No. 45 clarifies the requirements related to the recognition of a liability at the inception of a guarantee and requires recognition of the fair value of the obligation undertaken in issuing the guarantee. In certain circumstances, FASB Interpretation No. 45 requires no initial liability recognition but does prescribe disclosure of the guarantee.

6.53 In the airline industry, guarantees and indemnities are common and take many forms. The following are a few examples of guarantees in the airline industry: a parent's guarantee of its subsidiary's third-party debt or operating lease payments, guarantees contained in lease agreements, and guarantees of indebtedness of others.

6.54 FASB Interpretation No. 45 distinguishes between the noncontingent aspect of the guarantee (agreement by the guarantor to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur) and the contingent aspect of the guarantee (fulfillment of the guarantee if those triggering events or conditions occur). In situations in which recognition of a liability for the guarantee is required because the issuance of the guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions

occur, a liability for that guarantee should be recognized even though, based on guidance in FASB Statement No. 5, it is *not* probable that payments will be required under that guarantee. The objective of the initial measurement of the liability for the guarantee is the fair value of the guarantee at its inception. The airline needs to distinguish between guarantees requiring disclosure and guarantees requiring initial recognition. Paragraph 6 of FASB Interpretation No. 45 contains a list of guarantees and indemnities that are excluded from its scope, while paragraph 7 lists guarantees that are not subject to its initial recognition and measurement requirements but are subject to its disclosure requirements.

Parent's Guarantee of its Subsidiary's Third-Party Debt or Operating Lease Payments

6.55 An airline may issue debt or enter into a long term operating lease in conjunction with which the airline's parent company guarantees the airline's performance. Because the parent company is guaranteeing the consolidated entity's own performance, the guarantee is not subject to the recognition, measurement, and disclosure provisions of FASB Interpretation No. 45 in the consolidated financial statements.

Guarantees Contained in Lease Agreements

6.56 Aircraft and equipment lease agreements typically contain residual value guarantees (RVG). FASB Interpretation No. 45 does not apply to RVG under leases that the lessee accounts for as capital leases (because the accounting for a capital lease under FASB Statement No. 13 includes the amount of RVG in the calculation of the lessee's recognized liability for its obligations under the capital lease)**.** FASB Interpretation No. 45 does, however, apply to the recognition, measurement, and disclosure of RVG under leases that the lessee accounts for as operating leases.

6.57 Another common feature in an aircraft lease is a fixed-price purchase option whereby the lessee has an option to buy the aircraft at a specified date prior to the end of the lease term or at the end of the lease term for a fixed percentage of the lessor's original cost of the aircraft. A fixed-price purchase option is not a guarantee under FASB

Interpretation No. 45 because the lessee is not obligated to acquire the aircraft in the event that the fair value of the aircraft drops below the fixed price.

Guarantees of Indebtedness of Others

6.58 Airlines frequently guarantee the indebtedness of others, such as a member of airline's alliance or fuel consortium or a regional jet affiliate. In accordance with FASB Interpretation No. 45, this kind of guarantee requires recognition of the fair value of the airline's obligation to stand ready to perform under the guarantee. In practice, the value of a third-party guarantee could be based on present value differences between the terms of the debt that were available without the guarantee and the terms obtained with the guarantee. The contingent aspect of the guarantee—repayment of the debt by the airline in the event of default by the guaranteed party—should be accounted for using the recognition criteria of FASB Statement No. 5.

Inherent Risks

6.59 Inherent risks include the following:

- Complex nature of transactions in the airline industry
- Volume of agreements containing indemnities
- Difficulty in determining the fair value of certain indemnities and guarantees

Variable Interest Entities

6.60 A number of airlines have structures that need to be evaluated under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003),* to determine if they are variable interest entities (VIEs) and, if so, whether the airline is the primary beneficiary of the VIEs and needs to consolidate them. Examples of such structures include capacity purchase agreements, aircraft leases, enhanced equipment trust certificates (EETC), and airport fuel facilities. The lessors in airport facility leases that involve special facility revenue bond financings (discussed in the "Airport Financings" section of this chapter) are normally governmental entities. Governmental entities are scoped out of FASB Interpretation No. 46(R). An airline should determine whether it is the primary beneficiary of a VIE at the time it becomes

involved with the entity and should reconsider its conclusions regarding VIEs upon the occurrence of certain events listed in paragraphs 7 and 15 of FASB Interpretation No. 46(R). Also, if as a result of the airline's bankruptcy, agreements governing the relationship between the airline and VIE are modified, the airline needs to reevaluate its VIE decisions. Airlines need to prepare and maintain qualitative and, if necessary, quantitative evidence to support and provide rationale for their conclusions related to VIEs. The previous examples are not intended to be all inclusive, and the airline needs to evaluate all interests in entities for which one or more of the following conditions exist: (*a*) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders, (*b*) the equity investors do not have the characteristics of a controlling financial interest, or (*c*) the equity investors have voting rights that are not proportionate to their economic interests, and substantially all of the activities of the entity involve or are conducted on behalf of an investor with a disproportionately few voting rights.

Capacity Purchase Agreements

6.61 Capacity purchase agreements with regional airlines (which are discussed in detail in Chapter 9) should be evaluated under the requirements of FASB Interpretation No. 46(R). A regional carrier may qualify for the business exclusion discussed in paragraph 4(h) of FASB Interpretation No. 46(R), eliminating the need for further analysis and application of the interpretation. However, if (*a*) the major airline participates in the redesign of the regional airline, (*b*) the regional airline receives significant financing from the major airline, or (*c*) the contract provides substantially all of its operations, the regional would not qualify for the business exclusion and would have to be evaluated by the major airline to determine whether it is a VIE. Also, regional capacity purchase agreements should be evaluated under EITF Issue No. 01-8. Chapter 9 discusses criteria that need to be considered when determining whether a capacity purchase agreement contains a lease.

Aircraft Leases

6.62 A traditional form of aircraft financing is lease financing in which leasing trusts are established specifically to purchase, finance, and lease aircraft to the airlines. These leasing entities are potential VIEs. The typical leasing arrangements generally take the following forms: U.S. tax leases (leveraged leases from the lessor's perspective), single investor leases, multiple investor leases, or synthetic leases. The airline should analyze its lease arrangements to determine if a variable interest exists. However, operating leases that do not include a residual value guarantee (or similar arrangement) or fixed-price purchase option, and whose terms are consistent with prevailing market terms at the inception of the lease, are not considered variable interests in the lessor. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices are variable interests in the lessor entity if they meet the conditions described in paragraph 12 of FASB Interpretation No. 46(R). Alternatively, such arrangements may be variable interests in portions of a VIE as described in paragraph 13 of FASB Interpretation No. 46(R). If a variable interest exists, the airline needs to determine if the lessor entity is a VIE based on the criteria in paragraph 5 of FASB Interpretation No. 46(R). If the airline concludes that the entity is a VIE, which is generally the case with these arrangements, the next step is to determine whether the airline absorbs a majority of the VIE's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests and is, therefore, the primary beneficiary of the entity. An enterprise that holds significant variable interests in a VIE but is not the primary beneficiary is required to provide certain disclosures.

6.63 Generally, the fixed-price early buyout option and the fixed-price purchase option contained in lease agreements are the most common variable interests in the airline industry. They are considered variable interests because they entitle the airline to participate in increases in the value of the aircraft. However, unless the option is closely akin to a bargain purchase option, it is unlikely that the airline would have the majority of the expected losses or returns in these arrangements and, therefore, some other party would be the primary beneficiary.

Enhanced Equipment Trust Certificates

6.64 Airlines finance new aircraft acquisitions through EETC structures (discussed in Chapter 4 of this guide) that generally are VIEs because these structures contain multiple trusts that do not contain sufficient equity at risk. These structures can involve the airline assigning aircraft acquisition contracts to a financing trust, having the financing trust issue debt and equity, using the proceeds to acquire the aircraft, and then leasing the aircraft to the airline. Other structures involve the airline initially acquiring the aircraft through a debt or lease transaction and, at a later point, entering into an EETC transaction that includes a pool of leased aircraft and intermediary trusts to finance the acquisition of bank debt from the original creditors in the lease. Airlines need to evaluate whether they are the primary beneficiary of the trusts contained in EETC financings. Airlines should also evaluate whether these arrangements are subject to the sale-leaseback provisions of FASB Statement No. 28, *Accounting for Sales with Leasebacks.*

Airport Fuel Facilities

6.65 Airlines participate in numerous fuel consortiums with other airlines at major airports to reduce the costs of fuel distribution and storage. Some of these arrangements are governed by interline agreements that specify the rights and responsibilities of the consortium members and provide for the allocation of the overall costs to operate the consortium based on usage, while other fuel consortiums may be structured as limited liability partnerships or corporations. The consortiums (and in limited cases, the participating airlines) enter into long term agreements to lease certain airport fuel storage and distribution facilities that are typically financed through tax-exempt bonds (either special facilities lease revenue bonds or general airport revenue bonds) issued by various local municipalities. In general, the consortium lease agreement requires the consortium to make lease payments in amounts sufficient to pay the principal and interest payments on the bonds. Exposure to the principal amount of such bonds can be assessed based on the airline’s past consortium participation and will be triggered only if the other participating airlines or consortium members default on their lease payments.

Consortiums that are governed by interline agreements are not VIEs because they are not legal entities but rather are based on a contractual relationship.

Inherent Risks

6.66 Inherent risks include the following:

- Complex nature of these transactions
- Subjectivity of the "expected loss and expected return test"
- Volume of lease transactions
- Adequacy of available information regarding VIEs

Airport Financings

6.67 Airlines use special purpose revenue bond financings to construct major airport facilities. These bonds are issued by municipalities, government or airport authorities, or finance vehicles of these entities. The financings are typically guaranteed by the airline and are repaid from the lease payments made by the airline under long term operating leases with the respective government or airport authority. Under these lease agreements, the airline is required to make rental payments in amounts sufficient to pay the principal and interest payments on the bonds. It should be noted that these lease agreements contain terms that are more typical for debt agreements (that is, bullet maturity of principal, put provision for the debt at periodic intervals, or both) because they are structured so that the lease terms match the underlying debt terms. These arrangements are accounted for in accordance with the guidance in EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction," and No. 99-13, "Application of Issue No. 97-10 and FASB Interpretation No. 23 to Entities that Enter into Leases with Governmental Entities." Typically, in the construction of a new asset (for example, airport terminal financed with special facility revenue bonds), the airline serves as the construction manager in order to control the quality of the project or retain economic benefits. The airline also generally guarantees the construction period debt (special facility revenue bonds). If the airline is determined to have substantially all construction period risks, the asset and offsetting obligation are recognized on the airline's balance

sheet during the construction period. Once construction is complete and the lease begins, the airline needs to evaluate the sale-leaseback transaction under FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*, if the lease involves real estate or integral equipment; otherwise FASB Statement No. 28, is applicable. Generally, an airline will not be able to qualify for sale-leaseback treatment based on the criteria set forth in FASB Statement No. 98 due continuing involvement as defined in that Statement. As a result, the asset and offsetting obligation will remain on the airline's balance sheet after the construction is completed.

Inherent Risks

6.68 Inherent risks include the following:

- Complexity of airport financing
- Complexity of the accounting literature

Fuel Hedging

6.69 Because hedging is governed by very complex accounting literature, and because this section is intended merely to provide background information to help readers understand how hedging is used in the airline industry, readers should refer to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and interpretive accounting guidance when considering whether the measurement and disclosure of an entity's derivatives are in conformity with generally accepted accounting principles.

6.70 Fuel is a significant component of an airline's operating costs, and the price of jet fuel can be extremely volatile. Because airlines' operating results are affected significantly by the price of jet fuel, airlines may develop active jet fuel hedging programs to reduce their exposure to the volatility of jet fuel prices. Airlines typically use a combination of crude oil or heating oil derivatives to hedge their exposure. As an alternative to market-trading derivative contracts, airlines enter into fixed-price jet fuel

purchase contracts with suppliers, which allow them to purchase jet fuel at fixed prices. These nonmarket trading contracts should be evaluated to determine whether they must be accounted for as derivatives or whether they meet the normal purchases and normal sales exemption under FASB Statement No. 133 and related interpretations.

6.71 The airline will generally designate the derivative contract as a cash flow hedge of probable forecasted jet fuel deliveries. At hedge inception, the airline needs to prepare contemporaneous written documentation of the hedge relationship containing the following information, among other things:

- Specific identification of the hedging instrument (for example, crude oil or heating oil contracts)
- A description of the hedge transaction specifying the quantity and timing of the barrels to be purchased (for example, first 100,000 barrels in June)
- The nature of the risk being hedged, for example, changes in cash flows of the collar exposure beyond the strike prices are expected to offset the changes in cash flows of jet fuel purchases
- A discussion of how hedge effectiveness will be determined at hedge inception and on an ongoing basis for a period no longer than each quarter
- A discussion of how the airline will assess hedge effectiveness on a retrospective and prospective basis for a period no longer than each quarter
- A discussion of how the airline will measure hedge ineffectiveness

6.72 Because the jet fuel and the hedging derivative underlying are different commodities, the airline has basis risk due to location differences between the purchase location and derivative location, transportation costs, and refining costs. The airline must assess effectiveness consistent with its hedging documentation whenever financial statements or earnings are reported, and at least every three months. Accordingly, the airline must determine if the hedging derivative contract is “highly effective” in offsetting changes in the forecasted jet fuel purchases. Airlines typically use regression

models to determine the correlation of the percentage change in price of the derivatives used to hedge jet fuel to the percentage change in price of jet fuel.

Inherent Risks

6.73 Inherent risks include the following:

- Authorization of transactions
- Adequate diversification of counterparties
- Timeliness of documentation
- Inclusion of appropriate factors in assessing effectiveness (for example, crack spread and location)
- Assumptions used for determining hypothetical values
- Complexity of financial instruments used and the valuation

Insurance

Captive Insurance

6.74 Larger airlines may have captive insurance companies within their economic family of subsidiaries, either offshore in common locations like Bermuda and Grand Cayman or "onshore" (for U.S. companies) in locations like Vermont and Hawaii. Captive insurers are regulated by state or country insurance regulatory bodies, which also require audited financial statements.

6.75 Airlines may use captive insurers to fund or retain deductible risks or to access certain reinsurance companies interested in insuring aviation risks that for licensing, tax, or regulatory reasons cannot insure an airline directly within the policy syndicate. Airlines should consolidate the captive insurers that they control.

Insurer Insolvency

6.76 In case of an accident or incident, the airline should record a loss regardless of whether it has insurance. If an insured loss occurs, and if it is probable that the policy

will provide reimbursement for the loss and the amount of the reimbursement can be reasonably estimated, the airline should record a receivable from the insurance enterprise and a recovery of the incurred loss in the statement of operations. In situations in which the airline believes it will have to resort to legal action against the insurer to collect the reimbursement, AcSEC believes it would be inappropriate to record a receivable. It is important to note that, in some circumstances, losses and costs might be recognized in the statement of operations in a different (earlier) period than the related recovery.

6.77 Insurance company insolvency can be a significant issue for airlines. Aviation insurance is occurrence-based coverage, and accidents or incidents in the current year may take a number of years to completely pay out. During this period, an insurance company's financial condition can change significantly. Therefore, an insurer from past insurance programs could result in an uncollectible insurance payment today, causing the insured (airline) to re-assume the financial responsibility. The unusual syndicated structure of aviation insurance further increases the airlines' chances of having insolvent insurers in their current and past insurance policies.

6.78 Most airlines manage this risk when they purchase insurance by following financial security guidelines in the selection of insurers for their syndicates (S&P, Best's Insurance Rating, Fitch, and so forth). Also, risk management departments and insurance brokers monitor significant changes in financial ratings for current insurers and usually provide an annual review of significant changes in financial condition of past insurers to monitor insolvency risk.

6.79 Aviation insurance plays a major role in aircraft financing and debt arrangements, providing security in the event of loss affecting a secured interest and providing additional protection for financing groups, which may be named in airline operations-related lawsuits. To that end, many airlines have insurance-related contractual requirements affecting ability to self-insure certain risks, deductibles they can carry, the financial quality of insurers they insure with, kinds and amounts of insurance they need to carry, and other restrictions. The consequences of breaching these contractual

covenants, including their “cure” provisions, can be significant and may need to be disclosed.

Inherent Risks

6.80 Inherent risks include the following:

- Ability to obtain insurance and adequate coverage levels
- Consolidation issues for captive insurers
- Insurer insolvency risk

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Chapter 7

Financial Reporting and Disclosures

Introduction

7.01 This chapter discusses financial statement presentation and disclosure considerations as they relate to the airline industry. Airline industry disclosure topics are also included in other chapters of this guide. Disclosure topics covered in this chapter are those that are either significant or unique to the airline industry or are unique in an airline-specific application. The discussion in this chapter does not include other financial statement disclosures required by generally accepted accounting principles (GAAP) that are not significant or unique to the airline industry. For those nonairline-specific disclosures, readers may wish to refer to the AICPA *Checklists and Illustrative Financial Statements for Corporations,* which includes disclosures that should be considered by commercial corporations in preparing financial statements in conformity with GAAP. Practitioners may also find it helpful to review financial statements and related disclosures of specific airlines, most of which can be found on the Securities and Exchange Commission (SEC) Web site at www.sec.gov.

7.02 The disclosures discussed in this chapter that are identified with an asterisk (*) are applicable to companies subject to SEC reporting requirements that prepare their financial statements in conformity with GAAP pursuant to the SEC's reporting requirements. Items that are identified with an asterisk are *not* required to be disclosed by non-SEC reporting airlines.

7.03 A *public company*, as the term is used in this chapter, is a business enterprise that has issued debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional

markets), that is required to file financial statements with the SEC, or that provides financial statements for the purpose of issuing any class of securities in a public market.[12]

7.04 All other disclosures discussed in this chapter are applicable to all airlines (both SEC-reporting and non-SEC reporting). Some of those disclosures are required by authoritative literature and, therefore, should be included in financial statements prepared in conformity with GAAP, if applicable. This chapter also discusses a number of disclosure items that are not explicitly required by authoritative literature. The AICPA Accounting Standards Executive Committee (AcSEC) believes, however, that such disclosures are good industry practice and, therefore, recommends that airlines include them in their financial statements, if applicable. To distinguish such recommended disclosure items from the ones that are required, recommended disclosures are clearly identified in this chapter as being *encouraged* or *recommended*.

Accounting Policies and Disclosures

7.05 As required by Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*, disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. The financial statements should disclose accounting policies that involve a selection from existing alternatives, principles, and methods peculiar to the industry, or unusual or innovative applications of GAAP. Following are the areas typically considered in the selection and application of accounting policies related to airlines. Disclosures related to accounting policies that are required or recommended for airlines are also identified.

12 This definition is consistent with the definition provided in paragraph 9 of Financial Accounting Standards Board (FASB) Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information.*

Passenger and Other Revenue Recognition

7.06 A detailed discussion of the passenger revenue recognition processes and the related accounting issues for passenger ticket activities and other service activities is included in Chapter 3 of this guide.

7.07 Pursuant to APB Opinion No. 22, an airline should disclose its accounting policy for the recognition of revenue. Paragraph 12 of APB Opinion No. 22 states that "the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue . . . ." Passenger and other revenue recognition involves the use of judgments and estimates, which may have a significant effect on the airline's results. AcSEC believes the disclosure of significant accounting policies should include sufficient detail to allow users of the financial statements to understand the revenue recognition policies including the timing of when revenue is recognized, and AcSEC recommends that the disclosure include the methods used by management to develop estimates.

7.08 Unused tickets represent the main component of air traffic liability, and certain unused tickets are recognized in revenue using estimates. Significant changes in business conditions, passenger behavior, or both that affect these estimates could have a material effect on the financial statements. Accordingly, airlines should make any disclosures required by AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, Technical Practice Aids, ACC sec. 10,640). In addition, AcSEC recommends that airlines' policy disclosures for unused tickets discuss revenue breakage and highlight the use of estimates, historical experience factors, expiration dates, or other relevant data regarding the ticket terms and conditions.

7.09 For public companies, SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition,* provides that "because revenue recognition generally involves some level of judgment, the staff believes that a registrant should always disclose its revenue recognition policy. If a company has different policies for different types of revenue transactions, including barter sales, the policy for each material type of transaction should

be disclosed." An airline's major source of revenue relates to the sale of passenger tickets. Other sources of revenue may include the sale of miles to frequent flyer program (FFP) participants (see the "Frequent Flyer Programs" section that follows for further discussion), code sharing agreements with other airlines, and other fees such as change fees. If revenue related to code sharing arrangements is material, an airline is encouraged to include a description of where the revenue and the associated costs are presented in the statement of operations. **(SEC)***

Cargo Carriers Revenue Recognition

7.10 A detailed discussion of the cargo revenue recognition processes and the related accounting issues for air cargo activities is included in Chapter 8 of this guide. As indicated in the "Passenger and Other Revenue Recognition" section of this chapter, SAB No. 104 requires that public companies disclose their method of revenue recognition related to each major type of revenue-generating activity, which for cargo carriers typically includes package delivery, freight services, and logistics contracts. **(SEC)***

7.11 Because under Emerging Issues Task Force (EITF) Issue No. 91-9, "Revenue and Expense Recognition for Freight Services in Process," cargo airlines are allowed to select from four alternative acceptable methods of revenue recognition for in-transit shipments, consistent with the requirements of APB Opinion No. 22, cargo carriers should disclose the method applied including the nature and significance of the estimation process. Consistent with APB Opinion No. 22, cargo carriers should disclose the accounting polices regarding adjustments to revenue and accounts receivable relating to items such as money-back service guarantees and billing corrections, if material. Airlines should also make any disclosures required by SOP 94-6.

7.12 Transportation services may be provided by independent contractors. If material, consistent with the requirements of APB Opinion No. 22, an airline should disclose the method of revenue recognition related to logistics contracts where the company is considered either the principal (gross presentation) or the agent (net presentation) under

EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent." AcSEC also recommends disclosing components of revenue recorded on a net basis.

Frequent Flyer Programs

7.13 A detailed discussion of FFPs and the related accounting issues is included in Chapter 3 of this guide. The policies and estimation methods used to recognize service to be provided under FFPs have a significant effect on the measurement and recognition of revenue and costs related to those programs. Because there are two methods of accounting for FFPs, consistent with the requirements of APB Opinion No. 22, airlines should disclose the method adopted—that is, the incremental cost or the deferred revenue approach—as well as any material policy choices made in applying the method selected. For example, airlines using the incremental cost method should disclose their method of determining which frequent flyer credits a liability is recognized for and a description of the principal costs that are included in the determination of incremental cost, while airlines using the deferred revenue method should disclose their method of calculating the amount of revenue that is deferred and the method of subsequently recognizing that deferred revenue into revenue. Airlines should also disclose material changes in estimates related to FFPs in accordance with Financial Accounting Standards Board (FASB) Statement No. 154, *Accounting Changes and Error Corrections*. In addition, AcSEC recommends that airlines include the following disclosures in their financial statements in relation to FFPs:

- A description of the terms of the FFP
- The method of accounting for awards to be provided by other airlines and nonair travel awards
- For revenue from sales of frequent flyer miles or points, the classification of the marketing and travel components
- Disclosures related to the prepurchase of miles by a third party

*FFP Related Disclosures for Public Airlines (SEC)**

7.14 Public airlines generally provide expanded disclosures in their SEC filings concerning their frequent flyer travel award programs. These disclosures are typically shown in the "Description of the Business" section of the airline's SEC filings, although they may be included in the financial statements or in the "Management's Discussion and Analysis" (MD&A) section. Material changes in interim periods should be disclosed in quarterly reports on Form 10-Q. Common industry practice for public airlines is to disclose the following:

- The significant terms of any frequent flyer and other free travel award programs sponsored by the airline.
- The method of accounting for any frequent flyer and other free travel award programs, including the method of accounting for nontravel awards redeemed under the programs.
- If the incremental cost method is used, each material category of cost included in its measurement. In addition, a clear description of when the accrual is made and how the cost is estimated should be provided. If the liability established for provision of future services under the programs does not include a margin representing contribution to overhead or profit, that fact should be disclosed. The amount of the recorded liability or expense should be disclosed if it is material.
- The number of free travel awards outstanding at each balance sheet date (expressed in terms of mileage, equivalent revenue value, points, trips, or other similar measure). If the number of the awards outstanding does not include partially earned awards, the effect of this exclusion should be quantified.
- The number of awards expected to be redeemed for purposes of estimating the liability recorded by the airline at each balance sheet date. This may be expressed as a percentage of total awards outstanding. This disclosure should be accompanied by a description of the factors accounting for the difference between awards outstanding and awards expected to be redeemed, quantified to the extent practicable. The discussion should explain any material change in the ratio of expected redemptions to total outstanding awards that has occurred or may reasonably be expected to occur.

- The number of awards actually redeemed in the periods presented.
- The amount of free travel award usage expressed as a percentage of passenger miles flown for each period presented.
- If the displacement of revenue customers is reasonably likely and may materially affect liquidity or operating results, emerging trends should be described in the MD&A section of the annual report.

7.15 In addition, in accordance with SAB No. 104, for sales transactions that have multiple units of accounting (such as sales of frequent flyer miles or points), public airlines should state clearly in their accounting policy disclosures the accounting policy for each unit of accounting as well as how the units of accounting are determined and valued. **(SEC)***

Credit Card Holdbacks

7.16 Chapter 3 of this guide provides a discussion of the accounting for credit card holdbacks. If these amounts are material, airlines are encouraged to disclose the nature and terms of the arrangements, the balance of the holdbacks, and where the holdbacks are presented in the statement of financial position. Consistent with SOP 94-6, airlines should also consider disclosing conditions or covenants within these agreements that could materially affect the amount of the holdback.

Aircraft Acquisition Costs

7.17 Fixed assets and related accounting issues are discussed in Chapter 4 of this guide. If costs associated with the acquisition of aircraft and aircraft-related costs are material to an airline's financial statements, the airline should disclose its policies for accounting for such costs in accordance with APB Opinion No. 22.

Spare Parts

7.18 Spare parts and related accounting issues are discussed in Chapter 4 of this guide. If spare parts are material to the airline's financial statements, consistent with the requirements of APB Opinion No. 22, the airline should disclose its accounting policy, including the method used to value its spare parts and supplies, and the method used to establish an allowance for obsolescence, including residual value assumptions.

Maintenance and Repair Costs

7.19 The acceptable methods of accounting for maintenance and repair costs are described in Chapter 4. FASB Staff Position AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, requires disclosure of the method of accounting for planned major maintenance activities selected by an airline.

7.20 If the airline has contracted for maintenance on a basis other than for services as rendered (for example, power-by-the-hour contracts), disclosures are encouraged in sufficient detail to identify the method of determining payments under the contract, how the maintenance costs are recognized, and whether there are contingencies in the contract.

7.21 If an airline has lease agreements that require deposits or supplemental rent to be paid to the lessor that are to be used to reimburse the airline or third-party providers for maintenance of leased aircraft, the airline is encouraged to disclose how those payments are accounted for and where the related expense is classified in the statement of operations. If the airline has applied the deposit or prepaid expense method of accounting described in Chapter 4, AcSEC believes the airline also should consider disclosing the balance of the prepaid expense account as of the balance sheet date. In addition, for nonrefundable maintenance deposits (which, as discussed in Chapter 4, would be expensed if they are not probable of being used to fund future maintenance activities), the airline is encouraged to disclose its policy for evaluating the probability of those deposits being used to fund maintenance.

Leases

7.22 A detailed discussion of leases and related accounting issues is included in Chapter 4 of this guide. Paragraph 16 of FASB Statement No. 13, *Accounting for Leases*, provides the required disclosures for leases in the financial statements of a lessee.

*Lease Disclosure Considerations for Public Companies (SEC)**

7.23 In a 2005 letter to the AICPA, the Chief Accountant of the SEC emphasized that registrants should ensure that the disclosures regarding both operating and capital leases clearly and concisely address the material terms of and accounting for leases. In the airline industry, this might also include costs associated with lease return conditions that are accounted for as contingent rentals and airport leasehold improvements that are amortized over a period that is longer than the contractually stated lease term. These disclosures should provide basic descriptive information about material leases, usual contract terms, and specific provisions in leases relating to rent increases, rent holidays, contingent rents, and leasehold incentives. The accounting for leases should be clearly described in the notes to the financial statements and in the discussion of critical accounting policies in MD&A, if appropriate. Known likely trends or uncertainties in future rent or amortization expense that could materially affect future operating results or cash flows should be addressed in MD&A. The disclosures should address all of the following:

- Material lease agreements or arrangements
- The essential provisions of material leases, including the original term, renewal periods, reasonably assured rent escalations, rent holidays, contingent rent, rent concessions, leasehold improvement incentives, and unusual provisions or conditions
- The accounting policies for leases, including the treatment of each of the previously listed components of lease agreements

- The basis on which contingent rental payments are determined with specificity, not generality
- The amortization period of material leasehold improvements made either at the inception of the lease or during the lease term, and how the amortization period relates to the initial lease term

Asset Impairment

7.24 Issues related to the impairment of long-lived assets are discussed in Chapter 4 of this guide. Under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, airlines are required to perform an impairment test if events indicate that the asset's carrying amount may not be recoverable. Events or circumstances leading to an impairment of long-lived assets may include grounding or acceleration of aircraft retirement dates, regulatory changes, terrorist activities, significant negative industry or economic trends, significant changes in the use of the assets, or reduced passenger traffic and yields. AcSEC recommends that an airline's policy for the evaluation of the carrying amounts of long-lived assets be disclosed in the notes to the financial statements, including a description of how the airline measures an impairment loss.

7.25 Paragraphs 25 and 26 of FASB Statement No. 144 set forth disclosure requirements for impairment losses on long-lived assets to be held and used. If an impairment loss related to long-lived assets classified as held for use is included in the financial statements, the airline's disclosures shall include (*a*) a description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment; (*b*) if not separately presented on the face of the statement, the amount of the impairment loss and the caption in the statement of operations that includes that loss; (*c*) the method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique); (*d*) if applicable, the segment in which the impaired long-lived asset (asset group) is reported under FASB

Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

7.26 AcSEC encourages airlines to consider also disclosing the following matters:

- Future plans for the impaired assets
- The method for determining the lowest level at which assets are tested for impairment
- Management's policies for the review of the estimated useful lives and salvage values for aircraft and spare parts
- Significant assumptions used by management to estimate the fair value of the assets and the future cash flows, including discount rate, asset utilization, service life of the asset, and estimated salvage value
- Significant factors that indicated assets may be impaired and influenced the timing of loss recognition
- Anticipated fleet retirement or replacement schedules and pending aircraft orders

Restructuring and Special Charges

7.27 Due to a variety of economic and competitive factors, airlines may decide to reduce operations, exit certain markets, retire a fleet of aircraft, or otherwise exit operating activities or dispose of long-lived assets. FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, sets forth reporting and disclosure requirements for exit and disposal activities.

7.28 SAB No. 100, *Restructuring and Impairment Charges*, provides guidance regarding the extent of disclosures that should be included in MD&A related to restructuring and special charges. The SEC staff believes that it is necessary for a public company to present material exit and involuntary termination charges in tabular form, with the related liability balances and activity (for example, beginning balance, new charges, cash payments, other adjustments with explanations, and ending balances) from balance sheet date to balance sheet date to explain fully the components and effects of

significant restructuring charges. The SEC staff also stated its belief that MD&A should include discussion of the events and decisions that gave rise to the exit costs and exit plan, and the likely effects of management's plans on financial position, future operating results, and liquidity unless it is determined that a material effect is not reasonably likely to occur. This discussion should include whether the cost savings are expected to be offset by anticipated increases in other expenses or reduced revenues and clearly identify the income statement line items to be affected. Registrants should identify the periods in which material cash outlays are anticipated and the expected source of their funding. Registrants should also discuss material revisions to exit plans, exit costs, or the timing of the plan's execution, including the nature and reasons for the revisions. For exit costs and involuntary employee termination benefits relating to multiple exit plans, presentation of separate information for each individual exit plan that has a material effect on the balance sheet, results of operations, or cash flows generally is appropriate. A detailed discussion of issues related to labor relations, including severance benefits, is included in Chapter 5 of this guide. **(SEC)***

7.29 The SEC staff also has noted that the economic or other events that cause a registrant to consider or adopt an exit plan, or both, or that impair the carrying amount of assets generally occur over time. Accordingly, the SEC staff believes that, as those events and the resulting trends and uncertainties evolve, they often will meet the requirement for disclosure pursuant to the MD&A rules prior to the period in which the exit costs and liabilities are recorded pursuant to GAAP. Additionally, whether or not currently recognizable in the financial statements, material exit or involuntary termination costs that affect a known trend, demand, commitment, event, or uncertainty to management, should be disclosed in MD&A (for example, employee termination costs when the number of personnel to be terminated has been identified but the job classifications or functions and locations have not). **(SEC)***

7.30 In periods subsequent to the initiation date, material changes and activity in the liability balances of each significant type of exit cost and involuntary employee termination benefits (either as a result of expenditures or changes in or reversals of

estimates of the fair value of the liability) should be disclosed in the notes to the interim and annual financial statements and discussed in MD&A. Additionally, if actual savings anticipated by the exit plan are not achieved as expected or are achieved in periods other than as expected, MD&A should discuss that outcome, its reasons, and its likely effects on future operating results and liquidity. See the text of SAB No. 100 for details of the required disclosures. **(SEC)***

7.31 With respect to "special charges," the SEC staff has indicated its expectation that, to the extent that an airline takes a “special” charge not otherwise qualifying as a restructuring charge, disclosures similar to those accompanying a restructuring charge should be provided. **(SEC)***

Financing Arrangements

Variable Interest Entities

7.32 Airlines may have arrangements that need to be evaluated under the requirements of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (revised December 2003). Examples include capacity purchase agreements with regional carriers; aircraft leases that contain residual value guarantees or fixed price purchase options; financings using enhanced equipment trust certificates, and airport fuel facility consortiums. Common structures and the related accounting issues are discussed in Chapter 6. Paragraphs 23 through 26 of FASB Interpretation No. 46(R) set forth disclosure requirements for airlines that have a variable interest in a variable interest entity.

Derivative Instruments and Hedging Activities[13]

13 In December 2006, the FASB issued an exposure draft of a proposed statement, *Disclosures about Derivative Instruments and Hedging Activities* - an amendment of FASB Statement No. 133, the objective of which is to improve disclosures about derivatives accounted for in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Specifically, the proposed statement is expected to amend and expand the disclosure requirements in FASB Statement No. 133 with

7.33 Airlines enter into a wide variety of derivative instrument transactions to manage varying risks, including fuel price risk, interest rate risk, and foreign currency exchange rate risk. Chapter 6 discusses fuel hedging and related accounting issues.

7.34 Paragraphs 44 and 45 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, set forth disclosure requirements for derivative instruments. In accordance with paragraph 44 of FASB Statement No. 133, an airline that uses derivative instruments should disclose its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. The description shall distinguish between derivative instruments (and nonderivative instruments) designated as fair value hedging instruments, derivative instruments designated as cash flow hedging instruments, derivative instruments (and nonderivative instruments) designated as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, and all other derivatives. The disclosure also shall indicate the entity's risk management policy for each type of hedge, including a description of the items or transactions for which risks are hedged. For derivative instruments not designated as hedging instruments, the disclosure shall indicate the purpose of the derivative activity.

7.35 Airlines are encouraged to discuss their objectives and strategies in the context of their overall risk management profile. For SEC registrants, Regulation S-X, Rule 4-08(n) contains financial statement requirements for derivative instruments and hedging activities. **(SEC)***

Commitments and Contingencies

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the intent to provide an enhanced understanding of (*a*) how and why an entity uses derivative instruments, (*b*) how derivative instruments and related hedged items are accounted for under FASB Statement No. 133 and its related interpretations, and (*c*) how derivative instruments affect an entity's financial position, results of operations, and cash flows.

The final statement is expected to be issued in the fourth quarter of 2007. Readers should be alert to the issuance of the final statement.

7.36 An airline needs to evaluate its agreements and relationships with third parties to ensure its material contractual obligations and contingent liabilities are adequately disclosed in the notes to the financial statements. Commitments and contingencies typically disclosed by airlines include purchase commitments (including orders for aircraft and fuel purchase commitments), capacity purchase agreements, legal and environmental matters, lease arrangements, general guarantees and indemnifications, collective bargaining agreements (CBAs), and other employee matters. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, provides guidance on the disclosures to be made by a company in its interim and annual financial statements about its obligations under certain guarantees and indemnifications that it has issued.

Capacity Purchase Agreements

7.37 Major airlines typically contract with regional airlines to provide connecting service into the major airline's hub. These services are typically provided for under prorate or capacity purchase arrangements. A detailed discussion of prorate and capacity purchase arrangements and the related accounting issues is included in Chapter 9 of this guide.

Major Airline Disclosures

7.38 AcSEC recommends that the major airlines disclose the following with respect to capacity purchase agreements:

- The nature and terms of the agreement
- Any termination provisions
- Any minimum contractual commitments
- The statement of operations caption that includes the costs associated with a lease contained within a capacity purchase agreement
- A description of any contractual payments made to the regional airline along with a description of the arrangement

- If the major airline has a call option to acquire aircraft from the regional airline, the nature and terms of the arrangement, including conditions under which the option is exercisable

Regional Airline Disclosures

7.39 Because the determination of the appropriate presentation method for revenues and costs under capacity purchase agreements is driven by the nature and terms of the contracts involved (the regional's contract with the major and the contract to obtain the services), the same types of pass-through costs may be presented differently by different carriers. For example, based on different contractual relationships, one regional carrier may net fuel costs while another may reflect those costs and the related revenue on a gross basis. With respect to pass-through costs, AcSEC recommends that regional airlines consider making the following disclosures in the notes to their financial statements to assist readers in better understanding the regional's financial statements:

- The nature, terms, and amounts (which may require estimations and allocations) of contractual arrangements between the regional and major
- Costs that would ordinarily be required to be incurred in the operation of the regional airline consistent with service requirements of the capacity purchase agreement that are not being incurred because they are absorbed by the major, such as fuel obtained from the major without charge
- Gross transaction volume for revenue reported net, if reasonably determinable in accordance with paragraph 20 of EITF Issue No. 99-19

7.40 Airlines should also make any related-party disclosures required under FASB Statement No. 57, *Related Party Disclosures.*

Air Cargo Capacity Guarantees

7.41 As discussed in Chapter 8, some air cargo carriers provide aircraft, crew, maintenance, and insurance (ACMI) services to other air cargo carriers. Under these

ACMI contracts, customers receive dedicated aircraft capacity in exchange for a guaranteed minimum level of operation, which is generally expressed on an annual basis in the contract. AcSEC recommends that cargo carriers consider including the following disclosures in the notes to their financial statements to assist readers in better understanding their financial statements:

- A description of the carrier's revenue recognition policies related to AMCI contracts, including discussion of minimum payments and penalties
- A description of typical AMCI contractual terms, as well as any unusual terms related to significant contracts, and information regarding the timing and payment of minimum contractual amounts and penalties
- The percentage of revenue generated from AMCI contracts
- A discussion of expenses absorbed by the customer rather than the service provider under the terms of the contracts
- Future contractual minimum revenues expected from AMCI contracts

Segment Disclosures (SEC)*

7.42 FASB Statement No 131 establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports. It also establishes standards for related disclosures about products and services, geographic areas, and major customers.

Operating Segments

7.43 An operating segment is defined in FASB Statement No. 131 as a component of an enterprise:

a. That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise);

b. Whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and

c. For which discrete financial information is available.

7.44 FASB Statement No. 131 provides aggregation criteria and quantitative thresholds for determining which operating segments should be reported separately in the financial statements. Airline operations are often managed as a single business unit: air transportation, which includes the common carriage of passengers, freight, and mail over routes authorized by the Department of Transportation (DOT). Accordingly, many airlines disclose only a single reportable segment.

7.45 Some airlines manage their operations on a geographical basis, in which case each geographical operation might meet the definition of an operating segment. Those operating segments that meet the quantitative thresholds described in paragraph 18 of FASB Statement No. 131 should be reported separately unless they meet the aggregation criteria described in paragraph 17 of FASB Statement No. 131. Airlines often allocate operating revenues to geographic reportable segments based on the origin and destination of their flight segments. Information necessary to meet certain segment and geographical area disclosure requirements of FASB Statement No. 131 may, in some instances, be similar to that which airlines report to the DOT on Form 41 (see Chapter 10 for discussion of DOT Form 41). Because much of an airline's tangible operating equipment can be deployed across geographic markets, airlines often do not assign long-lived assets to geographical areas. When assets are assigned, certain assets, such as inventory and other ground facilities, may be directly attributable to a reportable segment and, therefore, are identified directly with that segment. Other assets are generally used in more than one segment and can be allocated to the segments by applying ratios similar to those used in the allocation of expenses.

7.46 According to paragraph 26 of FASB Statement No. 131, an airline is required to disclose the factors used to identify the enterprise’s reportable segments and the types of

products and services from which each reportable segment derives its revenues. The following sections highlight some of the factors that may be considered by the major, regional, and cargo carriers when identifying potential operating segments.

7.47 *Major Airlines.* If the major airline carrier operates a regional airline, a low-cost airline, or an all-cargo fleet within the larger airline, that operating unit should be evaluated to determine whether it qualifies as a separate operating segment.

7.48 *Regional Airlines.* If a regional airline has different types of revenue arrangements (for example, prorate and capacity purchase agreements), it needs to determine if the different revenue arrangements constitute separate operating segments. Additionally, a regional carrier may segregate operating revenue and expenses based on agreements with different capacity purchase partners or operating subsidiaries. In certain situations, in order to comply with provisions in their capacity purchase agreements, regional airlines form separate operating subsidiaries organized around Air Carrier Certificates ("operating certificates") issued by the DOT. These limitations, called scope restrictions, are imposed by the CBAs at the mainline carriers and typically specify the size of the aircraft that may be flown under the operating certificate of affiliated carriers. In order for the major airline to comply with these limitations, the regional carrier may be required under the capacity purchase agreement to segregate its aircraft by size or code-share partner, or both, under separate operating certificates. In so doing, the regional airline may also be segregating operating revenue and expenses by reporting subsidiary.

7.49 In the situations previously described, the regional airline may have discrete financial information for each type of revenue arrangement, capacity purchase agreement, or operating subsidiary, and the related discrete operating results may be regularly reviewed by the regional airline's chief operating decision maker to assess performance and make decisions about resource allocation. In those situations, the regional would to look to criteria set forth in paragraph 17 of FASB Statement No. 131 to determine if some or all of these operating segments could be aggregated into a single reportable segment.

7.50 *Cargo Carriers.* Cargo carriers typically segment their business using functional or geographic criteria or some hybrid thereof. Functionally, an airline might segregate operations that include delivery of cargo from forwarding services and logistics operations. Operations that deliver via aircraft or other express transportation may be segregated from ground delivery. Geographically, a business might segregate domestic operations from international or by a method of regional delineation. Often, a company may segregate its operations using functional criteria and further segregate using geographic criteria. For example, package operations may be broken into both domestic and international package operations.

7.51 *All Carriers.* In addition, carriers may have various subsidiaries or other business units that contribute to the operations of the airline. For example, they may have separate subsidiaries or businesses for the repair and maintenance of aircraft, food service, hotels, procurement of spare parts, or procurement of insurance. These operations need to be evaluated in accordance with FASB Statement No. 131 to determine if they should be reported separately.

Pensions and Other Postretirement Benefits

7.52 Obligations and costs related to pensions and other postretirement benefits are significant to many airlines. A detailed discussion of pensions and other postretirement benefits is included in Chapter 5 of this guide. For financial statement disclosure requirements for defined benefit plans and other postretirement benefits, readers should refer to FASB Statement No. 132(R) (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits,* as amended by FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.[14]

14 On September 29, 2006, the FASB issued FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* - an amendment of FASB Statements No. 87, 88, 106, and 132(R). FASB Statement No. 158 requires an employer to:

- Recognize in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status.

7.53 Changes in capital markets and interest rates can significantly affect the market value of employee benefit plan assets, as well as the assumptions used in determining the plan obligations, funded status, and expected future employer contributions. According to FASB Statement No. 132(R), an airline should explain any significant changes made to assumptions and give reasonable explanation concerning assumptions made. FASB Statement No. 132(R) requires disclosure of the benefits (as of the date of the latest statement of financial position presented) expected to be paid in each of the next five fiscal years and in the aggregate for the five fiscal years thereafter. Additionally, an airline is required to provide its best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented. Estimated contributions may be presented in the aggregate combining: (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

7.54 According to SEC Financial Reporting Release No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, if activity within an existing plan, such as earnings or returns on invested plan assets, has a material impact on the company's liquidity, capital resources, or results of operations, that activity should be discussed in MD&A. **(SEC)***

- Measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year (with limited exceptions).
- Recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income of a business entity and in changes in net assets of a not-for-profit organization.

FASB Statement No. 158 applies to plan sponsors that are public and private companies and nongovernmental not-for-profit organizations. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006, for entities with publicly traded equity securities, and at the end of the fiscal year ending after June 15, 2007, for all other entities. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008.

Risks and Uncertainties

7.55 In accordance with SOP 94-6, entities are required to provide disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas: nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations. These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by SOP 94-6 may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements. Disclosures in SEC filings regarding risk factors are discussed subsequently in this chapter.

7.56 In accordance with the requirements of SOP 94-6, an airline, like entities in other industries, should provide a brief description of the nature of its operations and a statement regarding the use of estimates in the preparation of financial statements. Disclosures regarding significant estimates may be made in the context of related disclosures, for example, in disclosures about impairment of assets, valuation of deferred tax assets, litigation-related obligations, and revenue breakage.

7.57 Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance. SOP 94-6 provides that certain concentrations should be disclosed if all of the following conditions are met: (*a*) the concentration exists at the date of the financial statements, (*b*) the concentration makes the enterprise vulnerable to the risk of near-term severe impact, and (*c*) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

7.58 In the airline industry, concentrations arise, for example, in the availability of labor resources or, especially at regional carriers, as a result of capacity purchase agreements.

7.59 SOP 94-6 provides that, for concentrations of labor subject to CBAs, disclosure should include both the percentage of the labor force covered by a CBA and the percentage of the labor force covered by a CBA that will expire within one year. Additionally, AcSEC recommends that airlines with labor force subject to CBAs disclose each employee group covered under a CBA, the amendable dates of the respective contracts, which contracts are open for negotiations, and the airline's accounting policy for expected retroactive wage increases under new or amended contracts. A detailed discussion of issues related to labor relations, including amendable labor contracts, is included in Chapter 5 of this guide.

7.60 AcSEC encourages regional airlines with capacity purchase agreements to discuss the stability of their major airline partner regardless of whether the disclosure criteria in SOP 94-6 are met.

Sales Taxes

7.61 A detailed discussion of the types of taxes and fees relating to the airline industry is included in Chapter 3.

7.62 EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)," requires disclosure of the accounting policy for any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer (that is, gross or net basis). For taxes reported on a gross basis, an airline should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. The disclosure of those taxes can be done on an aggregate basis.

Other SEC Disclosures (SEC)*

Risk Factors

7.63 Regulation S-K, Item 503(c), requires disclosure of significant business risk factors in SEC filings. A number of business risks exist in the airline industry, including the following:

- General economic conditions
- Geopolitical risks
- Competition
- Regulation
- International operations
- Service interruptions
- Price and availability of fuel
- Labor costs
- Pension and other postretirement obligations
- Insurance availability and costs
- Security costs and operational constraints
- Significant operating losses
- High levels of debt
- Interest rate changes
- Liquidity and airline bankruptcies
- Potential technology failures
- Safety issues
- Dependence on key personnel
- Reliance on a limited number of suppliers
- Aircraft utilization

7.64 Although this list is not complete, these and other risks in the airline industry should be considered for disclosure.

Critical Accounting Policies, Judgments, and Estimates

7.65 In a December 12, 2001, release, the SEC encouraged companies to provide in MD&A full explanations, in plain English, of their critical accounting policies, the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. In May 2002, the SEC published a proposed rule (Release No. 33-8098) requiring certain disclosures relating to accounting estimates and initial application of accounting policies. In December 2003, the SEC issued Release No. 33-8350, which is an interpretation providing guidance regarding MD&A disclosures. Included in that interpretation is a section regarding accounting estimates and assumptions that may be material, due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance. The release states that companies should consider enhanced discussion and analysis of these critical accounting estimates and assumptions that (*a*) supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements and (*b*) provides greater insight into the quality and variability of information regarding financial condition and operating performance. Readers should be alert to any final rules or additional interpretive materials published by the SEC.

7.66 An airline should evaluate its accounting policies and significant estimates to determine which ones should be identified as critical accounting policies, judgments, and estimates. Typically, airlines consider the following in their evaluation:

- Revenue recognition (passenger and cargo)
- Long-lived assets, including impairment
- Maintenance policies
- FFPs
- Employee benefit plans
- Goodwill and intangible assets, including impairment
- Derivative and other financial instruments
- Stock-based compensation

- Others as deemed significant to the reporting entity

Off-Balance Sheet Arrangements

7.67 Regulation S-K, Item 303(a)(4), contains MD&A disclosure requirements for off-balance sheet arrangements. The material facts and circumstances of off-balance-sheet arrangements such as guarantees, certain derivatives, retained interests, and variable interests should be disclosed in a separately captioned section of MD&A. The purpose of this disclosure is to provide investors with a clear understanding of the arrangements and their material effects on financial condition, changes in financial condition, revenues and expenses, results of operations, liquidity, capital expenditures, and capital resources. MD&A should also include other information that the company believes is necessary for an understanding of its off-balance-sheet arrangements and the specified material effects. More specifically, a company should disclose all of the following:

- The nature and business purpose of the off-balance-sheet arrangements
- The importance of off-balance-sheet arrangements to liquidity, capital resources, market risk support, credit risk support, or other benefits
- The overall magnitude of a company's off-balance-sheet activities, the specific material impact of the arrangements on a company, and the circumstances that could cause material contingent obligations or liabilities to come to fruition
- Any known event, demand, commitment, trend, or uncertainty that will, or is reasonably likely to, result in the termination, or material reduction in availability to the company, of its off-balance-sheet arrangements that provide the company with material benefits

7.68 The disclosure should cover the most recent fiscal year, but it should also address changes from the previous year. MD&A in quarterly reports should inform investors about material changes in the year-end disclosures.

Tabular Disclosure of Contractual Obligations

7.69 Regulation S-K, Item 303(a)(5) contains a requirement to disclose information related to contractual obligations. Disclosure is required in a tabular format of amounts of payments due under specified contractual obligations. The amounts are to be aggregated by category of contractual obligation for specified time periods. The company must present the information in a table but can determine where within the MD&A to include the table. The information should be as of the latest fiscal year-end balance sheet date, and the table should include separate disclosure of contractual obligations for long term debt, including interest, capital lease obligations, operating lease obligations, purchase obligations, including orders for aircraft, and, collectively, other long term liabilities reflected on the company's balance sheet in accordance with GAAP. The obligations should be disclosed in total for each category, and by period due, grouped by due in less than 1 year, due in 1–3 years, due in 3–5 years, and due in more than 5 years. Companies are not required to include this table in MD&A in quarterly reports. However, companies are expected to disclose material changes outside the ordinary course of business that arise during the interim period. Preparers should use judgment in determining the purchase obligations and other obligations to be included, and should include appropriate disclosure clearly describing items included and items excluded, as well as significant assumptions made in preparing the table. In addition to items previously discussed, airlines should include other items, if material, in the table of aggregate contractual obligations such as funding requirements for retirement plans and capacity purchase agreements.

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Chapter 8

Air Cargo Operations

Background

General

8.01 The air cargo industry consists of full-service air cargo airlines or dedicated fleets, regional operators, and passenger airlines that have air cargo operations (air cargo carriers). Air cargo carriers generate revenue primarily through the transportation of cargo and mail. Companies that act strictly as agents in the facilitation of air cargo shipments (typically referred to as freight forwarders) are not included within the scope of this guide. Air cargo may be in the form of palletized freight, individual parcels, or containers of commodities such as mail. Air cargo consists primarily of the following classes of service: priority mail (airmail and air parcel post), nonpriority mail (airlift of first-class mail on a space-available basis), foreign mail (mail destined to or from foreign countries), air express (priority movement of packages, generally under 50 pounds), and air freight (the airlift of palletized commodities).

Aircraft Crew Maintenance and Insurance Contracts

8.02 Some air cargo carriers provide aircraft, crew, maintenance, and insurance (ACMI) services for other airlines. Under an ACMI contract, customers receive dedicated aircraft capacity in exchange for a guaranteed minimum level of operation. ACMI contracts typically require customers to guarantee minimum aircraft utilization levels at fixed hourly rates and may be in effect for periods that can range from a day to up to five years, subject in certain limited cases to early termination provisions. These

contracts typically require the air cargo carrier to supply aircraft, crew, maintenance, and insurance, while the customers generally bear all other operating expenses, including:

- Fuel and fuel servicing
- Marketing costs associated with obtaining cargo
- Airport cargo handling
- Landing fees
- Ground handling, aircraft push-back, and de-icing services
- Specific cargo and mail insurance

8.03 The customers are also typically responsible under these contracts for utilizing the cargo capacity. As a result, ACMI contracts minimize the load factor, yield, and fuel cost risks traditionally associated with the air cargo business and provide a minimum annual revenue base and predictable profit margins. This model also allows customers to utilize an air cargo carrier's efficiencies to expand their presence in the world's cargo markets without committing to aircraft ownership.

8.04 There are multiple arrangements that are based on the ACMI contract model, including dedicated ACMI, fractional ACMI (or the provision of a portion of the capacity of one or more aircraft), and partial ACMI (or the provision of an aircraft on less than a full-time basis). These arrangements typically require customers to commit to certain utilization levels under seasonal contracts, and, in many instances, the revenue and cost structure vary from an ACMI contract because the operations may include arrangements for the provision of fuel and ground handling and flight-related expenses. An advantage of these arrangements is that risks that would otherwise be borne by a single customer, such as contract term, load factor, fuel, and ground handling, are shared among several parties. Under many ACMI contracts, the specific equipment or crew to be used is not part of the arrangement. However, the terms of ACMI contracts need to be evaluated under Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease."

Customs Services

8.05 Air cargo carriers may also generate revenue through the facilitation of customs clearance of various kinds of air cargo. As licensed customs clearance brokers, air cargo carriers are engaged by importers to prepare the documentation required for goods entering into specific countries. In this capacity, the air cargo carrier is responsible for coordinating all events and communicating the status of shipments from the time of shipment arrival through customs clearance. The air cargo carrier receives commercial and transportation documentation, reviews it for completeness and accuracy, prepares and files documents necessary to clear customs, obtains customs bonds, assists the importer in obtaining the appropriate commodity classification, and arranges for payment of collect freight charges. In many cases, the air cargo carrier also deposits import duties with the applicable customs service on behalf of the importer. In addition, the air cargo carrier may provide ancillary customs brokerage services to its customers, including placement of surety bonds, duty reduction programs, and duty drawback (recovery of duties paid when imported merchandise is re-exported). Some air cargo carriers also provide bonded warehouse services, which enable importers to defer payment of customs duties until the cargo is released from bond in conjunction with their production or distribution schedules.

Other Ancillary Services

8.06 Air cargo carriers may also provide other ancillary services, such as special handling and special services. Examples of special handling include transportation of perishable cargo, live animal transportation, offsize cargo, and transportation of dangerous goods (as governed by the International Air Transport Association). Special services include collection or delivery of shipments at customers' facilities; loading and off-loading; preparing cargo for transport using pallets, nets, and straps; and cargo insurance.

Accounting and Auditing Considerations

8.07 Operationally, nonpassenger airlines have many of the same characteristics of passenger airlines. The principal differences lie in the revenue recognition and measurement area, the accounting for cargo damage claims, and the accounting for the conversion of passenger aircraft to freighter aircraft.

Revenue Recognition and Measurement

8.08 Air cargo carriers' revenue is derived primarily from the carriage of cargo and mail and includes, among other things, revenue related to service options such as priority and express delivery preferences and fuel surcharges. Revenue recognition generally involves consideration of two factors: (*a*) being realized or realizable and (*b*) being earned.[15] Revenue is typically considered earned for air cargo carriers when the air cargo carrier provides the transportation service.

Revenue Recognition for Shipments in Transit at the End of a Reporting Period

8.09 For freight in transit at the end of a reporting period, revenue may be recognized using one of the methods allowed under EITF Issue No. 91-9, "Revenue and Expense Recognition for Freight Services in Process," provided the revenue is also realizable. Although EITF Issue No. 91-9 was directed specifically at motor carriers, the EITF noted that the consensus was not limited to motor carriers. EITF Issue No. 91-9 set forth acceptable methods of revenue and expense recognition for freight in transit at the end of a reporting period as follows:

- Recognition of revenue when freight is received from the shipper or when freight leaves the carrier's terminal with accrual of the estimated direct costs up to complete delivery of freight in transit
- Recognition of both revenue and direct cost when the shipment is completed

15 Financial Accounting Standards Board Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83.

- Recognition of revenue when the shipment is completed with expenses recognized as incurred
- Allocation of revenue between reporting periods based on relative transit time in each period with expenses recognized as incurred

8.10 In accordance with EITF Issue No. 91-9, it would not be appropriate for a carrier to change to the first method because revenue is recognized in advance of performance and liabilities are recognized before they are incurred. In practice, most air cargo carriers follow one of the last two methods.

Air Cargo Billing Revenue Process

8.11 The administrative and accounting aspects of the air cargo operation involve the processing required to route and trace shipments and to perform the accounts receivable and accounts payable functions for the associated shipping charges. Shipments and charges for each shipment are based on airbill information. The shipper or, in the case of an infrequent shipper, the air cargo carrier prepares an airbill when an air shipment is originated.

8.12 The air cargo carrier whose airbill is used for initiating and routing the shipment becomes the *issuing airline*; later, when transferring the shipment to another carrier, it becomes the *transferring airline*. The air cargo carrier accepting a transferred shipment becomes the *receiving airline*, and the air cargo carrier that terminates a shipment by delivery to the consignee becomes the *delivering airline*. In full-service air cargo operations, all of these functions may be performed by the same carrier.

8.13 The basic air cargo revenue accounting functions consist of airbill pricing and airbill invoicing. Airbill pricing includes establishing rates according to published tariffs, rate extension, and revenue apportionment between air cargo carriers. Airbill invoicing includes direct customer billing and interline settlement. Although standard rates typically are published or well known, air cargo carriers often give customer-specific

discounts or volume or time period discounts intended to promote increased capacity during lower volume times. These discounts must be recognized as the associated revenue is earned, which may vary depending on the specific terms of the discount arrangement.

8.14 This process is further complicated by rules regarding prepaid and collect shipments. On a prepaid shipment, the paid air cargo carrier is identified on the shipping instructions; therefore, downline air cargo carriers, if any, can bill directly to the paid carrier. However, on a collect shipment, upline air cargo carriers frequently do not know the identity of the collecting air cargo carrier because of shipment reroutings. Therefore, air cargo carriers that participate in a collect shipment perform "snowball" billing. Each air cargo carrier bills the adjacent downline air cargo carrier in the route segment for all transportation services up to the point of transfer to that air cargo carrier, thus snowballing the bills to the collecting air cargo carrier.

8.15 The issuing airline is responsible for retaining an accounting copy of each airbill, supplying airbill copies to the freight revenue accounting audit sections of participating air cargo carriers, and accepting invoices from delivering airlines for shipments carried on prepaid airbills. The delivering airline must accept invoices for collect shipments from the previous transferring airline and can invoice the issuing airline for actual transportation charges for prepaid shipments. Interline settlements are handled in the same manner as settlements of passenger ticket lifts, which are discussed in Chapter 3.

8.16 Because many air cargo airlines use cycle billings, there may be a time lag between the completion of a shipment and the generation of an invoice. Unprocessed transactions may contain a significant portion of air cargo carriers' total monthly revenue. This revenue should be recognized through systematic accrual processes. These processes typically include using actual package or shipment volumes and current trends of average revenue per shipment.

Reporting Revenue Gross Versus Net

8.17 Certain air cargo carriers use subcontractors as part of the transportation process, including agreements for fixed air cargo capacity. Additionally, certain air cargo carriers provide ancillary services such as third-party logistics and trade services. Examples include warehouse management, customs clearance transaction processing, and brokerage of transportation services. Also, some air cargo agreements provide for surcharges (for example, fuel surcharges that are intended to mitigate the impact of their higher fuel costs.) At issue is whether the revenue from such items should be reported at the gross amount billed to a customer (as a principal) versus at the net amount earned by the air cargo carrier in the transaction (as an agent). EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent," provides guidance on whether an entity should report revenue based on the gross amounts billed to a customer because it has earned revenue from the sale of the goods or services or the net amount retained (that is, the amounts billed to the customer less the amount paid to a supplier or subcontractor unless independently billed and collected by the supplier or subcontractor) because it has earned a commission or fee. The following indicators need to be considered when determining how to properly report revenue from such transactions.

8.18 Indicators of gross revenue reporting are as follows:

- The air cargo carrier is the "primary obligor" in the arrangement from the perspective of the customer.
- The air cargo carrier has general inventory risk in these arrangements if it has fixed capacity purchase agreements with subcontractors.
- The air cargo carrier has latitude in price-setting.
- The air cargo carrier changes the product or performs an additional service.
- The air cargo carrier has discretion in the selection of other parties used in the transportation process.
- The air cargo carrier has physical inventory loss risk (through claims for cargo loss or damage).
- The air cargo carrier has credit/collection risk.

8.19 Indicators of net revenue reporting are as follows:

- The supplier (not the air cargo carrier) is the "primary obligor" in the arrangement from the perspective of the customer.
- The amount earned by air cargo carrier is fixed.
- The supplier (not the air cargo carrier) has credit/collection risks.

8.20 As indicated in EITF Issue No. 99-19, the primary obligor and general inventory risk are strong indicators of gross reporting. However, EITF Issue No. 99-19 also states that the application of the indicators for gross and net reporting of revenue depends on the relevant facts and circumstances and requires significant judgment. Therefore, these strong indicators are not presumptive, and their absence would not require that revenue be reported net. If the air cargo carrier is clearly the principal to a contract, which is typical in the air cargo industry, revenue from sale of these air cargo services, including fuel or other surcharges, should be reported on a gross basis.

Other Ancillary Services

8.21 Some of the additional services discussed in the "Customs Services" and "Other Ancillary Services" sections in this chapter may qualify as separate deliverables and should be evaluated under EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," to determine whether deliverables represent separate units of accounting.

Capacity Guarantees

8.22 As was mentioned previously in this chapter, some air cargo carriers provide ACMI services to other air cargo carriers. Under these ACMI contracts, customers receive dedicated aircraft capacity in exchange for a guaranteed minimum level of operation, which is generally expressed on an annual basis in the contract. In these situations, customers could elect to exercise their contractual options to cancel a limited number of guaranteed hours. As a result, an air cargo carrier's revenue might decline as

contractual aircraft utilization levels temporarily decrease. Customers typically exercise such cancellation options early in the first quarter of the year, when the demand for air cargo capacity has historically been low, or following the seasonal holiday peak in the latter part of the fourth quarter.

8.23 ACMI contracts usually require customers to pay penalties for failure to meet minimum capacity guarantees. Such penalties are similar to contingent rental income and should be accounted for in a similar manner. EITF Issue No. 98-9, "Accounting for Contingent Rent," and Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*, provide that contingent rental income becomes accruable when the changes in the factors on which the contingent payments are based actually occur. If penalties are payable at the end of a contractual period, revenue related to penalties may be recognized only at the time when the customer actually fails to meet minimum capacity guarantees, not when it is probable that the customer will fail to meet minimum capacity guarantees.

Revenue Adjustments

8.24 In addition to provisions for credit losses on uncollectible accounts, air cargo carriers often have to make adjustments to revenue and accounts receivable for certain discounts, service guarantees, and billing corrections (which could result from pricing or rating issues). Also, certain air cargo carriers have programs whereby customers receive pricing adjustments if shipment service terms are not fully met. These adjustments are accounted for as a reduction of revenue at the time the revenue is recognized, typically based on historical payment experience.

Inherent Risk Factors

8.25 In assessing audit risk, the auditor should consider those factors that influence inherent risk related to revenue and accounts receivable. Such factors might include:

- The complexity of billing terms and conditions, including the extent of assessorial billings and surcharges

- The number and roles of multiple air cargo carriers involved in determining the total cost of the shipment, the revenue sharing, and gross versus net reporting of revenue
- The sophistication and reliability of systems and processes to capture data about shipments that is pertinent to revenue recognition
- The quality, timeliness, and relevance of data concerning historical credit losses, service failures, and billing corrections
- The period from the point of pick-up to delivery for the air cargo carrier

Cargo Claims Accruals

8.26 According to the Warsaw Convention, air cargo carriers have limited liability for damage sustained to cargo while in transit. Typically, air cargo carriers are liable in the event of loss or damage to cargo. Some air cargo carriers purchase insurance to cover any such damages, while other air cargo carriers are self-insured.

8.27 Air cargo carriers that are self-insured need to consider historical loss experience as well as present and expected levels of cost per claim when estimating this liability. The liability for cargo claims should take into account an estimate of incurred-but-not-reported claims and the potential salvage value of any damaged shipments retained by the air cargo carrier.

Inherent Risk Factors

8.28 The measurement of self-insurance obligations includes inherent risks that should be considered by the auditor. Such factors might include:

- The timeliness and accuracy of information about claims incidence and the effect that current trends may have on the data
- The periods involved in settling outstanding claims
- The amount of recovery, if any, on the subsequent sale of damaged cargo retained by the air cargo carrier

Passenger-to-Freighter Aircraft Conversions

8.29 Air cargo carriers often purchase passenger aircraft that are then converted to freighter aircraft. Passenger-to-freighter conversion involves primarily the removal of the passenger furnishings and installation of a main deck cargo door and cargo handling system. The conversion can be done by the manufacturer, the air cargo carrier, or another party.

8.30 Initial costs associated with the conversion, including heavy airframe and other costs necessary to get the aircraft ready for its intended use as a cargo freighter, should be capitalized. See Chapter 4 for additional discussion regarding costs incurred prior to used aircraft being placed into service.

8.31 Interest on funds used to finance the acquisition or modification of aircraft up to the date the aircraft is ready for its intended use should be capitalized and included in the cost of the aircraft. See the "Advanced Delivery Deposits and Capitalized Interest" section in Chapter 4 for more information. Depreciation of the costs incurred to modify airframes begins when the aircraft is placed into service and continues until the asset is permanently removed from service.

8.32 Rental costs on leased aircraft should be expensed on a straight-line basis over the lease term. Based on guidance in FASB Staff Position FAS 13-1, *Accounting for Rental Costs Incurred during a Construction Period*, the lease term begins when the air cargo carrier takes possession of or is given control of the leased aircraft. Accordingly, when the passenger-to-freighter conversion occurs during the lease term, rental costs of the leased aircraft should be expensed and not capitalized as part of the leasehold improvements.

Inherent Risk Factors

8.33 The accounting for passenger-to-freighter aircraft conversions involves inherent risk factors such as the following:

- The evaluation of whether a modification affects the useful life of the aircraft or represents routine maintenance on aircraft in service
- The applicable rate for interest capitalization
- The evaluation of the useful life and salvage value of a converted aircraft

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Chapter 9

Regional Airlines[16]

Introduction

History of Regional Airlines

9.01 Regional airlines were established in the 1980s for the purpose of providing air transportation to cities that were not capable of supporting major airline jet service. Regional airlines used smaller aircraft and provided connecting traffic from these cities into the hub cities of the major carriers. The major carrier and the regional carrier would create a joint marketing agreement whereby the airlines would coordinate their flight schedules to facilitate the interchange of passengers. Under these agreements, the major airline would allow the regional airline to use the major's reservation system and flight designator code to identify flights and fares in computer reservation systems; permit the regional carrier to use the major airline's paint scheme, logos, service marks, and uniforms; and provide for joint promotion and advertising. These agreements became known as *code-share agreements*. The advantage to both airlines was that each fed passengers to the other. At the inception of these agreements, regional airlines typically flew turboprop aircraft to connecting cities, usually within 250 to 500 miles of the major

16 This chapter contains numerous references to fair value. It does not reflect, however, the requirements of Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*, which provides enhanced guidance for using fair value to measure assets and liabilities. FASB Statement No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances.

FASB Statement No. 157 does not apply under accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value, including Emerging Issues Task Force (EITF) Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," which is also referred to in this chapter.

FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. This guide will be updated at a future date

airline's hub city. However, in the late 1990s with the advent of regional jets (generally defined as jet aircraft with fewer than 100 seats), the mission of the regional airlines began to evolve to include not only carrying connecting traffic into and out of hub cities, but also serving longer range connecting routes and certain other long, thinly traveled routes that traditionally had been operated by the major airlines with larger jet aircraft. The significant expansion in the operation of regional airlines in the 1990s occurred primarily as a result of their cost structure, which was lower than that of most of the major airlines due primarily to lower labor costs, thus providing an economical means of growing the major airline's route network with lower operating costs.

Effect of Collective Bargaining on Regional Airlines

9.02 The existence of collective bargaining agreements at major airlines contributed to the growth of independent regional airlines. Regional airlines can be profitable and are beneficial to the major airline only as long as their costs are lower than the major airline's costs. This profitability can be jeopardized if the wage scale at the major airline is implemented at the regional airline. Wage structures at wholly owned regional airlines are often affected when the collective bargaining agreement at the major airline opens for negotiation. Typical collective bargaining agreements provide a wage scale in which pilots' and flight attendants' wages increase as their seniority grows and the size of the aircraft they fly increases. These agreements usually result in higher wage scales for pilots and flight attendants who fly smaller aircraft for a major airline or a wholly owned subsidiary of a major airline than for pilots and flight attendants of independently owned regional airlines who do not fly larger aircraft. This condition, referred to as *regional carrier wage arbitrage*, has led to the growth of independently owned regional airlines.

9.03 The airline industry has also been affected by scope clauses in collective bargaining agreements at major airlines. These scope clauses frequently define the rules under which the major airline may expand through the use of regional jets either by the

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to reflect changes arising from FASB Statement No. 157.

major itself, by wholly owned regional airlines, or by contracting with independent regional airlines. If a major carrier expands by contracting with a regional carrier, jobs that would have been associated with additional flying by the major are lost to the regional airline. With the expansion of regional airlines (specifically regional jets in the 1990s), it became common for scope clauses to include a limit on the amount of flying that a major airline could contract to a regional airline, thus protecting the jobs of the major airline's employees. Scope clauses may include limits on the number of regional jets and the size of regional jets that may be flown by regional airlines (subsidiaries or contract carriers), or they may contain no such restrictions.

Revenue Sharing and the Evolution of Capacity Purchase Agreements

9.04 Revenue for passengers connecting from a regional carrier to a major carrier historically was split between the carriers in accordance with existing interline agreements (called *prorate agreements*), which typically prorated the revenue between the two carriers based on the distance each carrier flew the passenger. These arrangements were highly beneficial to the major carriers because they provided not only a proportion of revenue received from the passengers' tickets but also a feed of local passengers into the major carrier's system. As a result, a number of the major carriers began acquiring regional airlines for the purpose of feeding their hubs. Once major carriers owned regional carriers, it became evident that cost reductions could be achieved by having the major carrier provide certain operational and administrative services for the regional. Major airlines also saw a significant opportunity to expand the mission of their wholly owned regional subsidiaries to new markets and to provide more frequent service to existing markets by utilizing the regional carrier's smaller aircraft. As the benefit received by the major carriers went beyond revenue from the prorated ticket price, the benefit received by the regionals also evolved. The regional airlines sought to reduce their exposure to certain revenue and cost risks. Regional airlines achieved a reduction in risks associated with ticket price, load, and cost associated with ticket sales and fuel and facility costs by transferring them to the major carrier. New agreements were entered into

that required the major airline to price and sell all tickets on the regional airline's flights through the major airline's distribution channels. These agreements effectively transferred all passenger-related activities to the major; the regional would be contracted to simply operate the aircraft between two points and would be reimbursed for the costs plus a specified margin associated with that activity. These agreements eventually evolved into today's capacity purchase agreements.

Revenue

Prorate Agreements

9.05 Some regional airlines today still fly pursuant to prorate agreements with other carriers. Under these agreements, the passengers' fare is split between the two carriers generally based on the distance traveled by the passenger on each airline. In some cases, particularly when the regional carrier is owned by the major carrier, the major carrier may use other methods to determine the prorate value of the ticket. However, prorate agreements between major and regional airlines have evolved to meet the two parties' differing needs and now frequently include features such as fare minimums, connect incentives (fixed payments made by the major to the regional per passenger in addition to prorated revenue allocation), and other revenue incentives that help to minimize the revenue risk borne by the regional carrier.

9.06 Under prorate agreements, the regional carrier may be responsible for billing and collecting the value of the ticket from either the major carrier in the case of a code-share agreement or the ticketing carrier in the case of a standard interline agreement. Under prorate agreements, the airline that sells the ticket collects the fare from the passenger; the airline providing the transportation bills the collecting airline. This process is similar to interline billing between two airlines as discussed in Chapter 3.

9.07 When regional airlines fly pursuant to prorate agreements, actual processing of

tickets still takes place. The regional carrier may have its own revenue accounting department that processes all audit coupons and ticket lifts, or it may outsource some or all of this process. If the regional airline has its own revenue accounting department, revenue processing is similar to that of the major carriers (this is described in Chapter 3).

9.08 When the major carrier performs revenue processing for the regional, it aggregates all revenue that it processed for passengers carried by the regional. Upon closing the month, the major carrier issues a report of all passengers carried by the regional carrier and the revenue allocated to the regional carrier. The regional carrier then bills this amount to the major through the Airlines Clearing House (ACH). Alternatively, the major may choose to settle with the regional via regularly scheduled direct wire transfers. In such instances, the major may pay the regional throughout the month based on estimated allocated revenue and then settle at the end of the month based on actual allocated revenue. This process allows the regional to obtain some of the cash flow timing benefit that it would enjoy if it were to sell tickets itself.

9.09 Amounts billed to the major airline are often settled by netting revenue earned against the franchise fees paid to the major carrier for trademarks and marketing costs and the administrative cost for services performed by the major for the regional.

Capacity Purchase Agreements

9.10 Regional jet contracts between a major airline and a regional airline are frequently structured as capacity purchase agreements, which typically take one of two forms: fee-per-departure contracts or cost-based contracts. These contracts are similar in that they both require a payment to cover the regional airline's operating costs on a block-hour or flight-hour basis. Under these contracts, the major carrier purchases the use of the regional airline's aircraft and flight crews and other related services. The aircraft is painted in the colors and logos of the major airline, and the major airline also takes

responsibility for aircraft scheduling, ticket pricing, reservations, collections, and marketing. Ground handling of the aircraft may be performed by either the major carrier or the regional airline.

Fee-Per-Departure Contracts

9.11 Under fee-per-departure contracts, the regional carrier is compensated based on a rate per departure. The rate is intended to cover all of the costs and a profit margin for operation of the specified flight. This rate is generally either a per departure amount (for a specified origin and destination) or an amount per block hour of operation. These contracts also frequently provide for incentive payments based on operational performance, passenger volumes, and customer service. Fee-per-departure contracts may be annual or long term contracts. However, even long term contracts are frequently adjusted annually to consider certain changes in operating costs. See the "Other Contract Provisions" section of this chapter for guidance on revenue recognition in situations in which negotiations for new rates are not completed by year end.

Cost-Based Contracts

9.12 Under cost-based contracts, the regional carrier is compensated generally based on specific costs it incurs plus a margin. Typically, the regional carrier's revenue consists of three elements: (*a*) reimbursement of costs over which the regional carrier has control, referred to as controllable costs; (*b*) reimbursement of costs over which the regional carrier typically has no control, referred to as actual or pass-through costs; and (*c*) a profit or margin component.

9.13 The following illustrates the types of revenue derived from the typical cost-based contract. It should be noted, however, that all contracts are designed to meet the objectives of the major and regional airlines involved, and, accordingly, every contract is different and should be reviewed to ensure that proper accounting is being applied based

on the contract terms.

9.14 *Controllable Costs.* Controllable costs typically are reimbursed by the major airline at a fixed rate applied to some measure of operations (for example, flight hours, passengers carried, cycles, or block hours). Because the rate is fixed, the regional airline is at risk for this category of costs, and, if it does not manage its costs effectively, it will be less profitable. The following are examples of costs that are frequently included in this category, along with a brief description of each:

- *Crew wages.* Crew wages include costs associated with compensation of pilots and flight attendants on the aircraft. These costs may include the wages, benefits, per diems (meals and expenses), and lodging for each flight crew. Frequently, these costs are aggregated and expressed as a specific amount per flight hour.

- *Maintenance.* Maintenance includes costs required to maintain the aircraft. Maintenance cost is often computed based on the regional airline's history of performing maintenance on a given fleet of aircraft subject to required Federal Aviation Administration (FAA) maintenance schedules. Maintenance costs can also be derived from aircraft specifications and information from the aircraft vendors. Typical agreements provide for billing of maintenance costs to the major carrier based on a combination of fixed rates per flight hour, per departure, per aircraft, or other activity base. Regional airlines frequently outsource some or all of their aircraft maintenance activities. See the "Regional Carriers' Revenue Recognition—Capacity Purchase Agreements" section in this chapter for further discussion of this issue.

- *Ownership.* If the aircraft is owned, ownership costs include depreciation and interest on the aircraft. If the aircraft is leased, ownership costs include the lease payments on the aircraft. Ownership costs also include the cost of maintaining a spare parts inventory for the regional airline's fleet of aircraft and depreciation

expense on rotable inventory. Ownership cost is typically reimbursed at a fixed amount per aircraft. See the "Regional Carriers' Revenue Recognition—Capacity Purchase Agreement" section of this chapter for further discussion of this issue.

- *Customer service and ground handling.* Customer service and ground handling costs include costs incurred by the regional airline in the ground handling of the aircraft, customer service, terminal fees, rents, and security at terminals. Ground handling costs include the wages and benefits of baggage handlers and the cost of the equipment at the stations (belt loaders and tugs). Customer service costs consist primarily of the wages and benefits paid to customer service representatives at ticket counters and boarding gates. Terminal fees and rents include all variable and fixed terminal rent paid by the regional carrier. Variable rents are incurred based on a measure of activity, such as passengers carried, and are typically for common use areas. Fixed rents are for terminal and gate space. Security costs include any security provided by the regional air carrier, airport, or the Transportation Security Administration (TSA) that is paid for by the regional air carrier. In some contracts, terminal rent and security are treated as *actual costs* (see paragraph 9.16 of this chapter) that the regional carrier cannot control. In addition, the regional carrier may not incur some of these costs when operating at the major airline's hub airport or at other airports where the major airline performs customer service and ground handling services. See the "Presentation of Revenue and Expenses Under Capacity Purchase Agreements—Gross Versus Net" section in this chapter for a discussion of presentation of certain costs and revenue in the regional carrier's financial statements.

- *Overhead and administrative costs*. Overhead and administrative costs include compensation of employees who are not engaged in operational activities and facility costs, which include utilities and building maintenance. These costs may be reimbursed at a rate per activity measure, such as departures or passengers carried, or at a fixed amount per operations base.

9.15 While crew wages are generally included in controllable costs, the other costs previously described may also be included in pass-through costs in some capacity purchase agreements.

9.16 *Actual Costs (or Pass-Through Costs).* Actual costs typically are costs that are outside of the regional's control (for example, fuel costs) and, therefore, are reimbursed by the major airline on an actual cost or pass-through cost basis (see the "Presentation of Revenue and Expenses Under Capacity Purchase Agreements—Gross Versus Net" section in this chapter for a discussion of presentation of certain costs and revenue in the regional carrier's financial statements). The following costs are typically reimbursed under capacity purchase agreements on an actual cost or pass-through cost basis:

- *Landing fees.* Landing fees are established by the airport and assessed against the airline based on the weight of the aircraft and the number of landings made in a given month—typically, the heavier the aircraft, the higher the fee.

- *Facility rentals.* Facility rental costs are the cost of using terminal and other facilities necessary for the regional flight to take off or land.

- *Fuel.* Fuel costs include the actual price per gallon of jet fuel, the associated fuel taxes, and the cost to put the fuel into the aircraft (referred to as flow fees).

- *Property taxes.* Property taxes include all property taxes on aircraft, terminals, spare parts, and equipment used directly to provide service under the contract.

- *Insurance.* Insurance costs include all costs of insuring the aircraft and passengers.

9.17 *Costs Incurred by the Major Airline.* The regional carrier may or may not be billed by the major for certain products and services that the regional carrier obtains from the major carrier. These products and services tend to be kinds of items that would typically be in the actual-cost category, as well as customer service and ground handling in the major carrier's hub airport. Instead of billing the regional carrier for these items and then having the regional carrier bill them back, the major carrier may simply not bill the regional airline for these items. See the "Presentation of Revenue and Expenses Under Capacity Purchase Agreements—Gross Versus Net" section in this chapter.

9.18 *Profit Component.* Each cost-based contract may be unique in determining how the regional airline generates a profit from the services it performs. Profit may be derived from contractually stipulated performance bonuses based on the operations of the regional carrier, and, conversely, profit may be diminished by stipulated performance penalties for not meeting established operational goals. Performance is usually measured by certain operating statistics, and bonuses are usually defined by bands of performance (the better the performance, the higher the bonus, or, alternatively, poor performance can call for stipulated penalty payments by the regional carrier). In addition, profit on a regional contract is frequently derived by adding a margin or markup percentage to some or all controllable and actual costs. These markups sometimes also include so-called "margin collars," which serve to provide a floor and a cap to the amount of margin a regional carrier may earn either on an overall basis or on specific marginable cost categories. Alternatively, contracts may include only a margin cap. Care should be taken in analyzing contracts with margin collars because they may be interpreted differently by the parties.

Billing Process

9.19 Under capacity purchase agreements, regional airlines typically invoice their major airline partners using a two-step billing process that includes an estimated billing and a month-end billing that occurs shortly after month end (but generally before the

books are closed) when the majority of statistics and cost information are determinable. Because some costs are more difficult to determine, so-called "true-up billings" frequently occur after the month end to finalize billings for a particular period. It should be noted that a difference can and frequently does occur in the amount of revenue recognized by the regional carrier and the amount billed to the major in that period. A typical difference that can arise relates to changes in the price of fuel. The initial billing is frequently based on an estimate of the average price of fuel; actual fuel prices often vary from this estimate. The difference in the amount billed and the actual revenue recorded is settled in the subsequent true-up billing. The regional carrier should recognize revenue based on its estimate of the amount earned under the contract in each period. However, reconciliation of payable and receivable positions and confirmation of periodic settlements of prior periods with the major airline is a key control to determine if revenue has been recorded properly.

Recording Revenue

9.20 Operating statistics are critical to the determination of revenue under a capacity purchase agreement. Depending on the contract terms, some of the statistics that can affect the determination of revenue include departures, block hours, number of aircraft, and passengers. Because an airline typically can identify actual statistics several days after month end, revenue to be recognized can be determined several days after month end as well. The following is a general summary of the process of recording revenue under capacity purchase agreements.

9.21 With fee-per-departure contracts, once actual flight statistics become known, they are multiplied by the rate per departure, flight hour, or other operating statistic to determine actual revenue. The difference between the amount invoiced to the major carrier and the actual revenue recognized is recorded as a receivable or payable from or to the major carrier at month end.

9.22 With cost-based contracts, revenue is determined based on flight statistics, actual costs, and performance goals. Once actual flight statistics become known, they are multiplied by the rates for each of the controllable costs to determine actual revenue from controllable costs. Occasionally, there are differences in the statistics used by the regional carrier and the major carrier, which result in differences in the reimbursement for controllable costs as computed by the regional and by the major. Such differences are resolved by the carriers by verifying the differences against recorded flight statistics to determine the correct amounts.

9.23 Because some actual costs may not be known at month end, regional carriers estimate and accrue them and estimate the related revenue based on the corresponding expense accruals. To the extent that the accrued expenses differ from actual costs incurred, the recorded revenue would differ as well, thus resulting in a profit or loss effect to the extent of any profit margin on such costs.

9.24 Revenue from incentives earned by achieving specified operational targets (performance bonuses) is recorded based on the regional carrier's operational performance during the measurement period specified in the contract. Revenue is recognized when the factors on which the incentive payments are based actually occur and are not subject to change. In situations in which the measurement period specified in the contract extends beyond the financial reporting period, terms and conditions of the specific contract need to be evaluated to determine if it is appropriate to recognize revenue related to future incentive payments during the financial reporting period. The AICPA Accounting Standards Executive Committee (AcSEC) believes that it may be difficult to support interim recognition of annual performance incentives that are determined based on cumulative measurements and that an analogy to the guidance in Emerging Issues Task Force (EITF) Topic No. D-96, "Accounting for Management Fees Based on a Formula," should be considered. Airlines should also consider guidance provided in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition.*

9.25 The amounts calculated for controllable costs are added to the estimate of revenue from actual costs and performance related items, and the total is recorded as revenue for the month.

Accounting Issues

9.26 It should be noted that this chapter focuses on accounting issues that are unique to regional carriers. In addition to this chapter, regional carriers should refer to other chapters of this guide that address topics that are relevant for both regional and major carriers.

Regional Carriers' Revenue Recognition—Capacity Purchase Agreements

General Approach

9.27 Historically, regional airlines recognized revenue under capacity purchase agreements upon the completion of the specified flight. However, in 2003, the EITF issued EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," and finalized EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," which affected how regional airlines analyzed revenue recognition for capacity purchase agreements. The following is a brief overview of the analysis that is performed for each capacity purchase agreement.

9.28 The first step in analyzing a capacity purchase agreement for revenue recognition purposes is to determine whether the agreement contains a lease under EITF Issue No. 01-8. If the portion of the agreement related to the use or acquisition of the aircraft qualifies as a lease under EITF Issue No. 01-8, the next step is to consider separation of lease and related executory costs from nonlease elements based on relative fair values in accordance with EITF Issue No. 00-21. Lease and related executory cost elements should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*.

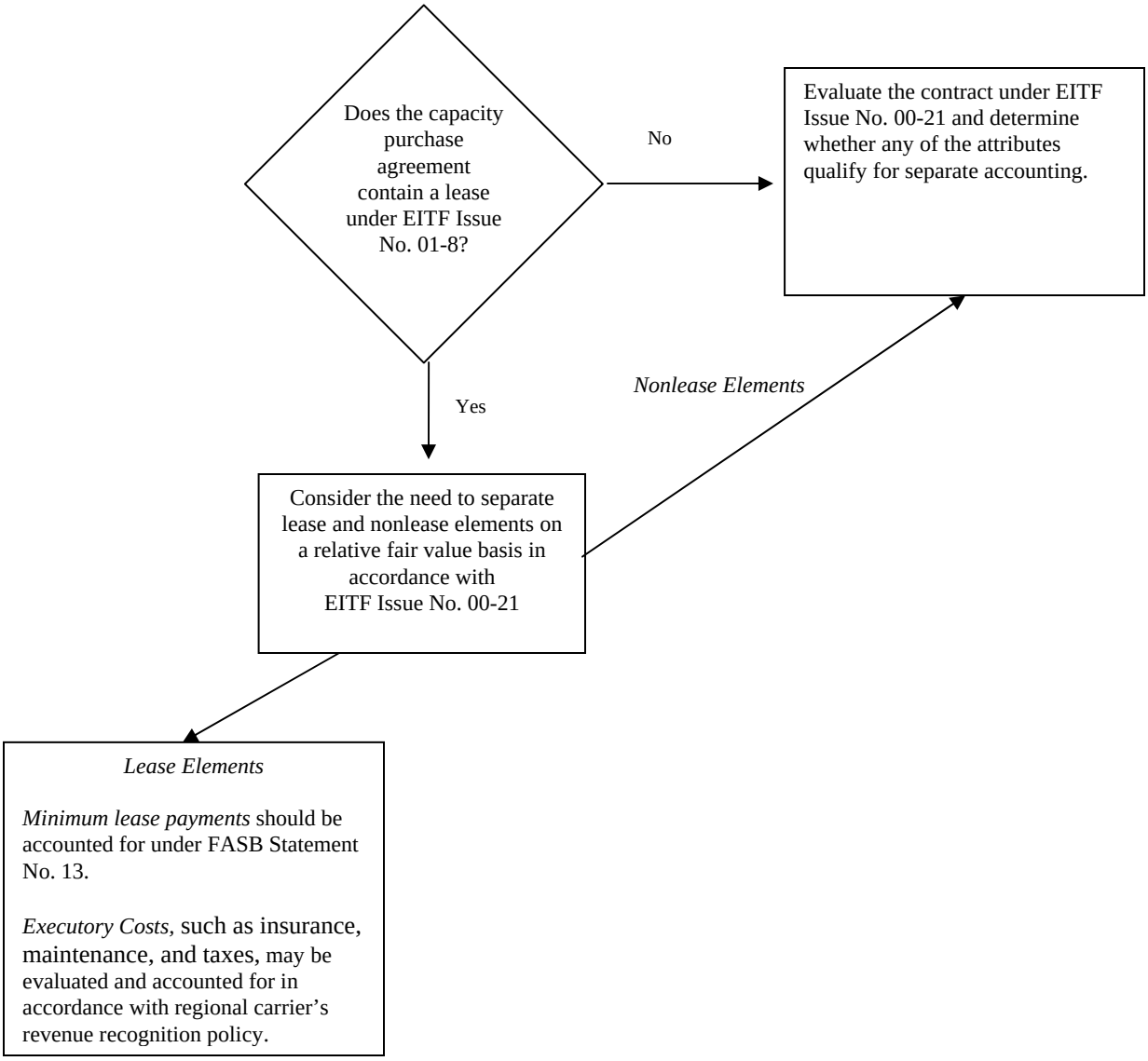
Nonlease elements are evaluated under EITF Issue No. 00-21 to determine if there are separate units of accounting and how each unit should be accounted for under relevant accounting literature.

9.29 In practice, the terms of substantially all capacity purchase agreements (as described previously in this chapter) are such that the regional airline would generally conclude that a capacity purchase agreement contains a lease under EITF Issue No. 01-8. However, if it is determined that the capacity purchase agreement does not contain a lease under EITF Issue No. 01-8 or if EITF Issue No. 01-8 does not apply due to its transition provisions, the airline would apply the provisions of EITF Issue No. 00-21 to the entire contract. That would generally not result in multiple units of accounting under EITF Issue No. 00-21 because substantially all of the services provided under the capacity purchase agreement (for example, flight crew and planned major maintenance) would not meet the criteria in paragraph 9 of EITF Issue No. 00-21 to be considered separate units of accounting because their value is substantially dependent on delivery of the aircraft and because they would have no value to the customer on a standalone basis. AcSEC believes that such capacity purchase agreements should be viewed as arrangements to transport passengers between two points, not arrangements to perform the separate activities necessary to operate the flight, and that the completion of a flight under such a capacity purchase agreement is the best measure of performance completion and is the appropriate time to recognize revenue for the flight. Services performed under such capacity purchase agreements by the regional for the major that are not part of the activities necessary to transport passengers may qualify for separation under EITF Issue No. 00-21 as discussed in the "Consideration of EITF Issue No. 00-21" section that follows.

9.30 The remainder of the discussion in this chapter focuses on accounting for a capacity purchase agreement containing a lease under EITF Issue No. 01-8.

9.31 If the aircraft is considered leased under EITF Issue No. 01-8, and therefore ascribed to the major airline, the majority of the other services provided under the capacity purchase agreement could be separated for accounting evaluation by virtue of their having separate value to the major airline. Separation, if it occurred, would likely not result in recognition of revenue at a time other than the flight date for the majority of the services as described subsequently in this chapter. Separation might, however, result in revenue recognition at a different time for certain activities such as planned major maintenance based on its unique pattern of costs and delivery and additional accounting guidance that may apply to those services.

9.32 The flowchart that follows depicts the analysis of capacity purchase agreements. Guidance on application of this model is provided in the sections that follow.



Consideration of EITF Issue No. 01-8—Lease Revenue Embedded in a Capacity Purchase Agreement

9.33 Two general criteria need to be considered when determining whether a capacity purchase agreement contains a lease: (*a*) whether fulfillment of the agreement depends on the use of specified property, plant, or equipment and (*b*) whether a right to control the use of the specified property, plant, or equipment is conveyed to the major airline under

the capacity purchase agreement. The evaluation of whether these criteria are met is subjective; however, EITF Issue No. 01-8 contains specific considerations and examples to assist in the evaluation.

9.34 Both criteria are typically met in regional airline capacity purchase agreements, and, accordingly, payments received in connection with the use or acquisition of aircraft and related executory costs would generally be accounted for under FASB Statement No. 13. These criteria are met in most capacity purchase agreements because (*a*) the aircraft are dedicated to the major partner, including being painted in the major airline's colors and livery, and, (*b*) although the regional airline may have a legal ability to operate the aircraft under its own code, the terms and operational requirements of the capacity purchase agreements generally make such operation impractical. Furthermore, to provide for operational continuation during scheduled maintenance activities or for other reasons, most capacity purchase agreements permit only a limited substitution of nonbranded aircraft. AcSEC believes that EITF Issue No. 01-8 applies regardless of whether the aircraft is owned or leased by the regional airline and regardless of the form of capacity purchase agreement (that is, it applies to both fee-per-departure and cost-based contracts).

9.35 Under EITF Issue No. 01-8, the regional airline must first separate the portion of the capacity purchase agreement that pertains to the procurement of aircraft and related executory costs (*lease costs*) from the portion of the agreement that pertains to other than payments for a capital asset and related executory costs (that is, from payments for other services). The allocation of the arrangement consideration between lease and nonlease costs should be made in accordance with paragraph 4(a) of EITF Issue No. 00-21, which is on a relative fair value basis using the entity's best estimate of the fair value of the deliverables. Determining the portion of the agreement related to the aircraft can be reasonably simple for cost-based contracts because the reimbursement for the aircraft is frequently specified in the contract on a per-flight-hour or per-month basis. Lease-related executory costs should also be separated as part of the process (executory costs are

discussed subsequently in this section). However, if the amounts attributable to lease and nonlease costs are not readily determinable, as would generally be the case in the traditional fee-per-departure contract, the contract payments should be allocated using the regional airline's best estimate of fair value of the lease and nonlease costs in relation to other services provided under the capacity purchase agreement. Once the portion of the contract payments attributable to the aircraft and related executory costs is determined, that payment stream must be evaluated under FASB Statement No. 13. The minimum lease payments under the lease, excluding those for executory costs, should be evaluated under FASB Statement No. 13 to determine the proper classification of the lease.

9.36 FASB Statement No. 13 provides that executory costs such as insurance, maintenance, and taxes, together with any profit thereon, shall be excluded from minimum lease payments. Therefore, executory costs would be separated from the costs related to the procurement of the aircraft. This separation is further supported by footnote 3 of EITF Issue No. 00-21. As discussed in the "Revenue Recognition for Planned Major Maintenance Activities" section in this chapter, it is unclear whether payments related to planned major maintenance activities are considered executory costs as that term is used in FASB Statement No. 13. However, AcSEC believes that even if such payments were not considered executory costs, they still would not meet the definition of minimum lease payments in FASB Statement No. 13.

9.37 Determination of the lease term under a capacity purchase agreement can be difficult because these agreements are frequently long term (for example, 10 to 20 years) but contain multiple provisions for termination by either party. In most cases, the lease term is either the full term of the agreement or the period when the agreement cannot be cancelled by the major carrier without cause (referred to herein as the *minimum contract period*). In determining whether the lease term should be based on the minimum contract period, consideration should be given to penalties associated with cancellation of the contract. Such penalties may be monetary or economic (for example, if the major carrier has no substantially equivalent aircraft in its own fleet, canceling the capacity purchase

agreement could force the major to downsize its operations due to inability to serve routes that require regional jets). If the regional airline concludes that the minimum contract period should be used as the lease term, it should evaluate any cancellation provisions that would permit the regional airline to demand additional payments from the major. These provisions may need to be considered as a component of minimum lease payments for the purpose of applying paragraphs 7 and 8 of FASB Statement No. 13 to determine the proper classification of a lease.

9.38 Because each capacity purchase agreement is different, regional airlines need to evaluate the effect of EITF Issue No. 01-8 on the accounting for those contracts on a contract-by-contract basis.

Consideration of EITF Issue No. 00-21

9.39 After the separation of lease elements as previously described, the nonlease elements are then further evaluated under EITF Issue No. 00-21 to determine if there are separate units of accounting and how each unit should be accounted for under relevant generally accepted accounting principles.

9.40 Paragraph 9 of EITF Issue No. 00-21 provides that, in an arrangement with multiple deliverables, the delivered item(s) should be considered a separate unit of accounting if all of the following criteria are met:

- The delivered item(s) has value to the customer on a standalone basis. That item(s) has value on a standalone basis *if it is sold separately by any vendor* or the customer could resell the delivered item(s) on a standalone basis. In the context of a customer's ability to resell the delivered item(s), the EITF observed that this criterion does not require the existence of an observable market for that deliverable(s).

- There is objective and reliable evidence of the fair value of the undelivered item(s).
- If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

9.41 Based on the criteria set forth in the preceding list, the regional carrier should assess whether the delivered item has value on a standalone basis and specifically address whether any vendor sells that item separately. If the criteria set forth in paragraph 9 of EITF Issue No. 00-21 are not met, the deliverable does not qualify to be accounted for as a separate unit of accounting.

9.42 Certain deliverables provided under a capacity purchase agreement that contains a lease, such as flight crew and fuel, could qualify as separate units of accounting under the guidance in EITF Issue No. 00-21 because they are likely to meet the criteria in paragraph 9 of EITF Issue No. 00-21. In particular, because the major airline is viewed as the operator of the aircraft (by virtue of being the lessee of the aircraft under EITF Issue No. 01-8), the provision of services under the contract by the regional carrier has value to the major airline because if the regional carrier did not provide those services, the major airline would have to obtain them elsewhere to operate the aircraft (for example, pay its own pilots to fly the aircraft or purchase fuel on its own). However, the application of EITF Issue No. 00-21 to these separate elements would likely not result in a different revenue recognition pattern because there is no separate revenue recognition literature that applies to these other flight-related components (for example, flight crew, fuel, and other services), and recognition as of flight completion would still generally be appropriate because the earnings process is complete at that point. The regional carrier should evaluate costs reimbursed under its capacity purchase agreement to ensure that this assessment is appropriate in its particular circumstances.

Revenue Recognition for Planned Major Maintenance Activities

9.43 Under most capacity purchase agreements, the major airline reimburses the regional airline for planned major maintenance, and these payments may not coincide with the performance of the maintenance services. As indicated previously, AcSEC believes it is unclear whether payments related to planned major maintenance activities are considered executory costs as that term is used in FASB Statement No. 13. Therefore, AcSEC believes there are two acceptable approaches to account for revenue related to planned major maintenance when the regional airline has concluded that a capacity purchase agreement contains a lease under EITF Issue No. 01-8: regional airlines may choose to consider payments related to planned major maintenance as reimbursement of an executory cost as defined in FASB Statement No. 13 or account for maintenance-related revenue following FASB Technical Bulletin (FTB) 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*. AcSEC believes that the regional airline should select one of these methods and apply it consistently to all agreements. Under both approaches, the lease and related executory costs (including the planned major maintenance activities) would be separated from the nonlease elements based on relative fair values as previously described. After that, the airline would apply one of the two accounting models that are discussed in the following sections. It is assumed in these sections that the regional airline uses the expense as incurred method of accounting for planned major maintenance activities. See Chapter 4 for a discussion of acceptable methods of accounting for planned major maintenance activities.

9.44 *FASB Statement No. 13 Approach.* Under this accounting model, maintenance is viewed as reimbursement of an executory cost, as defined in FASB Statement No. 13, and revenue related to maintenance would be treated similarly to supplemental rent and would be recognized on a straight-line basis over the lease term (as described previously in this chapter). The regional airline would first separate from the lease element previously determined the portion of the payments under the capacity purchase agreement related to planned major maintenance activities, including a profit thereon (the

residual would then represent minimum lease payments to be accounted for under FASB Statement No. 13). To accomplish this, a regional airline would generally estimate payments projected to be received for planned major maintenance activities over the lease term (including a profit thereon) and the number of flight hours expected to be flown over this period to determine a constant rate per flight hour. AcSEC recommends that regional airlines use a rate per flight hour or some other measure of utilization of the aircraft to recognize revenue related to planned major maintenance because these factors more appropriately measure maintenance services performed. If at any time the amount of recognized revenue related to planned major maintenance exceeds the amount of reimbursements received, the regional airline would need to evaluate realizability of the resulting receivable.

9.45 *FTB 90-1 Approach.* Under this model, the airline would analogize to FTB 90-1 to determine how to recognize revenue related to planned major maintenance under a capacity purchase agreement. Paragraph 3 of FTB 90-1 states:

> Revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

9.46 AcSEC believes this guidance should be applied at the capacity purchase agreement or fleet type level (if the capacity purchase agreement specifies independent terms for different fleets) over the lease term (as described previously in this chapter).

9.47 Under the FTB 90-1 method, the element pertaining to the planned major maintenance activity would be considered a nonlease element and would therefore be valued based on the relative fair values of all the elements in the capacity purchase agreement. Applying the FTB 90-1 method would produce results that are most likely

similar to the FASB Statement No. 13 approach, provided it is concluded that revenue should be recognized on a straight-line basis. However, airlines likely to elect this approach are those that believe their cost pattern is significantly different from straight-line and, as a result, believe FTB 90-1 would provide a better model to match the cost of the planned major maintenance activities with the related revenue. The following examples are provided to illustrate how a regional airline might use the guidance of FTB 90-1 to account for planned major maintenance revenues. It is assumed in these illustrations that the costs of planned major maintenance activities are incurred on other than a straight-line basis and that the airline has sufficient historical experience or objective evidence to support the cost pattern:

- *Maintenance-related payments are received in proportion to the cost of performing the planned major maintenance activities.* This may be the case in a contract covering a mature fleet that has relatively steady annual planned major maintenance costs over the lease term and consistent anticipated annual revenue under the capacity purchase agreement. This could also happen if the payments related to planned major maintenance are received on a pass-through basis (that is, as the related costs are incurred) and, therefore, directly match the cost of the planned major maintenance activities on a per incident basis. In these situations, applying the guidance of FTB 90-1 would result in revenue for planned major maintenance activities being recognized as received under the contract because revenue would be received in proportion to the costs expected to be incurred to perform the services, based on the airline's historical experience or other objective evidence. In these examples, revenue would not be deferred; however, it would not be recognized on a straight-line basis because maintenance costs do tend to increase over time as an aircraft ages.

- *Maintenance-related payments are not received in proportion to the costs of the planned major maintenance activities.* This might occur if a regional airline has a new fleet of aircraft that will require little or no planned major maintenance in the first few years and if the related capacity purchase agreement requires reimbursement of costs on a basis that will be relatively stable over the lease

term. In this example, when applying guidance of FTB 90-1, the regional airline would defer revenue under the capacity purchase agreement and recognize it in proportion to the costs expected to be incurred in performing the planned major maintenance over the lease term.

9.48 The preceding examples are provided for illustrative purposes only and are not intended to cover all possible scenarios and outcomes. Therefore, specific facts and circumstances need to be carefully evaluated to ensure that guidance contained in FTB 90-1 is applied properly.

9.49 In applying the guidance in FTB 90-1, the regional airline should also be aware of special situations, for example, in which planned major maintenance activities will occur after the end of the lease term. Revenue related to such activities is recognized in proportion to only those costs that are expected to be incurred within the lease term, which may lead to recognizing revenue before recognizing a significant portion of expenses related to planned major maintenance. For example, if a capacity purchase agreement has a term of two years (which in this example is assumed to be equal to the lease term) and planned major maintenance will be performed in three years, all revenue attributable to maintenance is recognized by the end of the second year, which is the end of the lease term, while the majority of maintenance expenses will be recognized when incurred in the third year, assuming the regional airline uses the expense as incurred method of accounting for planned major maintenance activities.

9.50 Finally, when applying the guidance of FTB 90-1, the regional carrier should evaluate the expected pattern of maintenance-related costs and should not default to recognizing revenue on a straight-line basis because of the lack of sufficient historical evidence regarding such costs. Although the evaluation of the expected pattern of maintenance-related costs should focus on future maintenance-related cash outflows, historical evidence about past costs, if available, should be used to assist in that

evaluation. If the carrier does not have sufficient historical evidence on which to base its estimate of future maintenance costs, such information should be obtained from maintenance service providers or other sources.

Up-Front Contract Payments

9.51 When a regional airline enters into a new capacity purchase agreement with a major airline or, less frequently, when the contract is modified, for example, to include additional aircraft or make a significant modification to the service offering or model, the regional airline performs certain activities at the request of the major carrier to support the new contract or activities. These activities include, for example, painting the exterior and reconfiguring the interior of the aircraft to conform to the décor of the major airline and training customer service personnel in the use of the major airline's reservation system.

9.52 The cost of certain of these activities is often reimbursed by the major carrier pursuant to the capacity purchase agreement. Reimbursement may be paid at contract initiation, or it may be paid later. For example, costs associated with the integration of new aircraft into an existing contract would generally be paid as the aircraft are introduced.

9.53 As discussed previously, the regional carrier needs to evaluate activities described in the preceding paragraphs of this section under EITF Issue No. 00-21 to determine whether they qualify to be accounted for as separate units of accounting. Generally, in a capacity purchase agreement that contains a lease (which is the most prevalent structure of those arrangements), services provided by the regional to prepare its aircraft for operations for the major carrier and to train its employees would not qualify as separate units of accounting under EITF Issue No. 00-21 because they would have no value to the major on a standalone basis. For example, in the case of training, the regional is training its own pilots who will operate planes for the major carrier. Trained pilots of the regional

carrier have no value to the major absent regional's performance under the contract. However, if the regional trains pilots working for the major, those trained pilots would have value to the major carrier on a standalone basis because they could be used by the major on its other aircraft, and the training deliverable would qualify as a separate unit of accounting.

9.54 Furthermore, the guidance in SAB No. 104 with respect to nonrefundable up-front fees would likely result in the deferral of revenue. SAB No. 104 states that:

> …the on-going rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the up-front payment. Therefore, the up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an integrated package. In such circumstances, the staff believes that up-front fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance and generally should be deferred and recognized systematically over the periods that the fees are earned.

9.55 AcSEC believes that the major pays the up-front fees for services provided by the regional (for example, training or painting the aircraft) solely to facilitate the provision of flights under the capacity purchase agreement and that, as such, the provisions of SAB No. 104 should be applied, which, in most cases, would result in revenue recognition over the term of the capacity purchase agreement for such up-front payments.

9.56 The nature of direct costs associated with providing these services should be evaluated to determine whether they should be capitalized or expensed. For example, costs incurred to paint the exterior and reconfigure the interior of the aircraft to conform to the décor of the major airline might be either expensed or capitalized depending on the airline's asset capitalization policy for its aircraft, as discussed in Chapter 4. The regional airline should be aware that the useful lives of any capital assets may be affected by the term of the contract or other contractual provisions (for example, if the initial painting of

the aircraft in the major's color scheme is determined to be a capital asset, its life would generally be limited to the contract term).

9.57 Some costs incurred by the regional airline for which it is reimbursed by the major as part of up-front contract payments (for example, training) may not qualify for capitalization. This may result in revenue from up-front payments being deferred and amortized over the contract term, while the related expense would be recognized in earnings when incurred. However, in situations in which the regional airline concludes that the revenue should be deferred, other types of costs (for example, training and aircraft reconfiguration costs that are not capitalizable under the airline's asset capitalization policy) may qualify for capitalization as an asset provided they meet the requirements of EITF Issue No. 99-5, "Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements," which states:

> The Task Force reached a consensus for Issue 4 that if a contractual guarantee for reimbursement exists for design and development costs that otherwise would be expensed under the consensuses on this Issue, those costs should be recognized as an asset as incurred. For purposes of this Issue, contractual guarantee means a legally enforceable agreement in which the amount of reimbursement can be objectively measured and verified.

9.58 This provision would generally be met in situations in which the reimbursement is received up-front or the contract specifically provides for such reimbursement in the future, including upon a contract termination. The capitalized costs would generally be amortized over the contract period in proportion to the revenue recognized, provided the transaction meets the criteria for gross reporting under EITF Issue No. 99-19 "Reporting Revenue Gross as a Principal versus Net as an Agent."

Presentation of Revenue and Expenses Under Capacity Purchase Agreements—Gross Versus Net

9.59 Industry practice among the regional airlines for capacity purchase agreements is

uniform, with revenue and expenses generally reported on a modified gross basis (that is, revenue reflects amounts billed to the major carrier under the capacity purchase agreement, and operating expenses are reported by separate category in operating expenses).

9.60 Regional airlines traditionally have recognized as an expense the costs incurred by the major carrier in connection with the operation of the major carrier's flight if the major carrier billed the regional for those costs and if they recognized revenue for the amount rebilled to the major (a *gross presentation*). However, if the regional was not billed by the major for those costs, the regional recognized neither the expense nor the related revenue (a *net presentation*). For example, if the regional carrier used its major partner's terminal space at the major carrier's hub location, the major carrier billed the regional for the terminal space, and the regional re-billed the major for that cost (generally as a component of actual or pass-through costs under the capacity purchase agreement), the regional would recognize the expense and related revenue in its statement of operations. However, if the regional was not billed by the major for the use of that space (that is, the major simply absorbed the cost of facilities used by the regional and did not bill the regional at all), the regional airline's statement of operations would exclude that expense and related revenue. As a result, costs such as fuel, facilities, ground handling, and landing fees have been treated differently among regional carriers depending on the terms of the contract between the regional and major airline. It should be noted that expenses incurred by the major in connection with activities not performed by the regional under a capacity purchase agreement are attributed to the major and are not billed to the regional. For example, under a typical capacity purchase agreement, the regional must simply operate the aircraft from one point to another point and has no obligation to sell tickets. Accordingly, costs related to ticketing such as commissions and computer reservations systems (CRS fees) would not be within the scope of services provided by the regional under the capacity purchase agreement, would not relate to the services performed by the regional, would be incurred by the major, and would not be recognized by the regional as expenses or revenue.

9.61 AcSEC believes that, in determining whether pass-through costs should be presented gross or net, regional carriers should follow the guidance in EITF Issue No. 99-19. In EITF Issue No. 99-19, the EITF concluded that gross versus net presentation is a matter of judgment that depends on the relevant facts and circumstances, and it set forth factors or indicators that should be considered in that evaluation. Accordingly, regional carriers should consider the terms of the capacity purchase agreement as well as the nature and terms of the underlying contracts to acquire services that are reimbursed by the major carrier. That should include pass-through costs incurred by the major carrier that pertain directly to the scope of operations prescribed under the capacity purchase agreement and that are necessary for the completion of the operation of the flight. Each kind of pass-through cost should be evaluated individually.

9.62 None of the factors or indicators set forth in EITF Issue No. 99-19 is considered presumptive or determinative; the relative strength of each indicator should be considered. However, AcSEC believes that, in the context of pass-through costs under capacity purchase agreements, certain factors are likely to be more significant than others. Those factors are discussed in the paragraphs that follow. AcSEC believes the guidance in those paragraphs is also supported by EITF Issue No. 01-14, “Income Statement Characterization of Reimbursements Received for 'Out-of-Pocket' Expenses Incurred.”

Indicators of Gross Revenue Reporting

9.63 *Regional Has Supplier Discretion.* If the regional airline has discretion in selecting the supplier to provide the services whose cost would be the basis for revenue recognition, that may indicate that the regional is primarily responsible for the fulfillment of those services and that the regional should present revenue and expense gross. In these situations, the regional frequently has other indicators of gross presentation as well, such as being the primary obligor to the supplier.

9.64 *Regional Is the Primary Obligor.* The regional airline is the primary obligor if it contracts for the service and performs substantially all execution actions under the contract, which would generally include being obligated to pay for the contract. For example, regional airlines frequently purchase fuel directly at outstations from the local airport fuel provider and are then reimbursed for the cost of the fuel by the major airline. In these transactions, the regional airline is the primary obligor because it executes a purchase contract with the fuel provider and pays for the fuel.

9.65 *Regional Has Credit Risk.* The regional airline would generally have credit risk for services purchased if it must pay the amount owed to a supplier after the supplier performs, regardless of whether it is reimbursed fully by the major airline.

Indicators of Net Revenue Reporting

9.66 *Lack of Supplier Discretion.* If the regional airline is directed by its contract with the major airline to procure services from a particular vendor with no ability to change vendors, that may indicate that the regional is not primarily responsible for the operating expenses that would be the basis for revenue recognition and that the cost of those services and the related revenue should be reported net. For example, if the capacity purchase agreement requires that certain services be obtained only from the major partner, the cost of those services and the related revenue would generally meet the requirements for net presentation. Lack of supplier discretion may result from economic compulsion as well as from contractual restrictions.

9.67 *Major Is the Primary Obligor.* If the major airline is the primary obligor in a supplier agreement under which the regional airline procures goods or services, including arrangements under which the supplier would look directly to the major airline for settlement, that is strong evidence of net reporting.

9.68 AcSEC believes that the primary obligor and supplier discretion are the main criteria in the determination of gross versus net presentation of pass-through costs. However, absence of one of the indicators in the relationship with the major airline does not always indicate that the agreement should be presented on a net basis in the regional airline's financial statements.

Disclosures

9.69 See Chapter 7 for disclosure considerations related to presentation of revenue and expenses under capacity purchase agreements.

Other Contract Provisions

Annual Contract Component Negotiations

9.70 Long term fee-per-departure contracts generally establish base rates that are subject to annual adjustment for certain cost components. Most contracts allow the regional airline to continue billing the major airline at the currently agreed rates while new annual rates are being negotiated until the new rates are finalized. AcSEC recommends that regional airlines follow the guidance in SAB No. 104 in recognizing revenue during the negotiation period. Fixed or determinable sales price is one of the revenue recognition criteria discussed in SAB No. 104. AcSEC believes that situations in which the rates are expected to decline and the regional carrier may be required to refund the major carrier for the difference in rates during the negotiation period are similar to price concessions discussed in SOP 00-2, *Accounting by Producers or Distributors of Films* (AICPA, *Technical Practice Aids*, ACC sec. 10,800). Consistent with the guidance in SOP 00-2, AcSEC believes that airlines should provide appropriate allowances for such refunds. If rates are expected to increase, the regional airline should continue to bill and recognize revenue under the terms of the previous agreement until such increases in rates are formally agreed to. If adjustments from the prior contract are made based on

management's judgment, that fact should be disclosed as part of the regional airline's revenue recognition policy.

Termination Provisions

9.71 Capacity purchase agreements typically include termination provisions under which the major carrier or the regional carrier may early-terminate the agreement. For the major carrier, these provisions typically involve standards of performance to which the regional carrier must adhere, including on-time performance, completion percentage, baggage handling, or other conditions such as changes in control and financial viability. For the regional carrier, termination provisions may include requirements concerning the timing of payments and the continued viability of the major carrier.

9.72 To alleviate certain financial and operational risks associated with these termination provisions, capacity purchase agreements may also contain provisions for "puts" and "calls" on the aircraft the regional carrier is flying in service for the major carrier. Because it is typically the regional carrier's responsibility to procure and finance the aircraft flown under capacity purchase agreements, and because the useful life of owned aircraft and lease term for leased aircraft often exceed the term of the capacity purchase agreement between the regional carrier and the major carrier, the regional carrier has cost exposure for the useful life or lease term that exceeds the term of the capacity purchase agreement. A remedy for this exposure is to include "put" terms in the agreement whereby the regional carrier has the option to require the major carrier to assume the lease of the underlying aircraft in certain situations including contract termination. The opposite situation may also occur in which the major carrier desires to continue the use of the regional carrier's aircraft after contract termination, whether early or not. A remedy to the major carrier in this case is to include "call" terms in the agreement, under which the major carrier has the option to require the regional carrier to sell or transfer the lease of the underlying aircraft to the major carrier. The existence of the provisions and the conditions that would result in these contingencies should be

disclosed clearly in the notes to the financial statements. Also, put and call provisions should be evaluated to determine if they are in substance residual value guarantees or bargain purchase options for purposes of applying paragraphs 7 and 8 of FASB Statement No. 13 to determine the proper classification of a lease. The terms of call provisions may affect the regional carrier's depreciation and lease accounting if the regional carrier leases the aircraft.

Inherent Risk Factors

9.73 In assessing audit risk, the auditor should consider those factors that influence inherent risk related to the recording of capacity purchase revenue, including factors related to management, interpretation of contract terms, customer relationships, and characteristics of the airline industry. Examples of such factors follow:

- *Manual journal entries.* Capacity purchase agreements typically are lengthy and are recorded in the financial records by manual journal entries, which are subject to manipulation and management override.
- *Complexity of capacity purchase agreements.* Capacity purchase agreements are typically lengthy and complex documents that often contain terms that are subject to interpretation by both the regional carrier and the major carrier. Differences in interpretation may lead to billing disputes and collection issues.
- *Existence of multiple information systems that capture and store actual flight statistics.* The largest single determinant of contract billings is the actual flight statistics. Air carriers may have multiple information systems that capture and store these statistics, and differences in data between these systems are not uncommon. These discrepancies may be significant and are driven by differences in data inputs, linkages between systems, timing, and occasionally data corruption within one or more systems
- *Creditworthiness of major airline.* Collectibility of accounts receivable amounts outstanding is subject to dispute resolution or the credit worthiness of the major airline partner.

- *Adjustments to billings.* Subsequent true-ups or adjustments to billings may be an indication that either contract terms have not been fully evaluated or processes for capturing pass-through costs may not be appropriate.
- *Gross versus net.* If costs statistics (including cost per available seat mile) are not reasonable in comparison with peer companies, this may be an indication of inappropriate gross versus net evaluation.

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Chapter 10

Special Reports and Example Reporting

Omitted from the exposure draft.

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Glossary

Airbill. The nonnegotiable shipping document used by domestic air carriers as evidence of an air freight shipment. The document contains shipping instructions, commodity descriptions, and transportation charges applicable to the freight shipped. Sometimes the term is used interchangeably with *air waybill*.

Air cargo. In the United States, the total volume of freight, mail, and express traffic that is transported by air. U.S. air cargo consists of the following classes of service: priority mail (airmail and air parcel post), nonpriority mail (airlift of first-class mail on a space available basis), foreign mail (mail destined to or from foreign countries), air express (priority movement of packages, generally under 50 pounds), and air freight (the airlift of palletized commodities).

Air carrier. A person who undertakes directly by lease or any other arrangement to engage in air transportation.

Aircraft, crew, maintenance, and insurance (ACMI) contract. Contracts under which air cargo carriers provide aircraft, crew, maintenance, and insurance services for other airlines. Under an ACMI contract, customers receive dedicated aircraft capacity in exchange for a guaranteed minimum level of operation. ACMI contracts typically require customers to guarantee minimum aircraft utilization levels at fixed hourly rates and may be in effect for periods that can range from a day to up to five years.

Aircraft miles flown. The miles (computed in airport-to-airport distances) for each flight stage actually completed, regardless of whether it was performed in accordance with the scheduled pattern. For this purpose, operation to a flag stop is a stage completed, even though a landing is not actually made. In cases in which the interairport distances are inapplicable, aircraft miles flown are determined by multiplying the normal cruising speed for the aircraft type by the airborne hours.

Aircraft modifications. Modifications made to interior configurations of aircraft—including the reconfiguration and replacement of customer service-related assets such as seats, galley equipment, in-flight entertainment systems, and storage bin space—typically in response to market forces and passenger demands, as well as modifications arising from airworthiness directives. See **airworthiness directives**.

Aircraft servicing expense. Compensation of ground personnel and other expenses incurred on the ground incident to the protection and control of the in-flight movement of the aircraft; scheduling or preparation of aircraft operational crews for flight assignment; landing and parking of aircraft; visual inspection; routing, checking, servicing, and fueling of aircraft; and other expenses incurred on the ground incident to readying for aircraft arrival and takeoff.

Airframe. The structure of an aircraft, excluding engines and accessories. The principal parts of the airframe of an airplane include the fuselage (the body), wings, empennage (the assembly of stabilizing and control surfaces at the tail), landing gear, and nacelles or pods (engine housings).

Airport operating rights. These rights represent the value inherent in a carrier's established operations at certain airports. Generally, this intangible asset exists at airports which have some or all of the following characteristics: significant barriers to entry exist at the airport, the airport is capacity constrained, or an airline has a substantial portion of the airport's capacity. An example would be an airline's operations at either its hub location or at a high-density, capacity-constrained airport that is not slot controlled.

Air traffic liability (ATL). The value of air transportation services sold but as yet unused by the passenger, including sales for air transportation to be provided by the reporting air carrier and air transportation to be provided by another air carrier for whom sales were made. This is sometimes referred to as *unearned transportation revenue*.

Air traffic liability (ATL) breakage. Recorded ticket sales that remain partially or wholly unused after either the scheduled departure date or ticket expiration date. Historically, ATL breakage has included both the revenue breakage and invalid tickets. See **revenue breakage** and **invalid ticket.**

Airworthiness. The ability of a particular aircraft or component part to perform its function satisfactorily through a range of operations determined by the Federal Aviation Administration (FAA). See **airworthiness directives**.

Airworthiness directives. Airworthiness directives (ADs)are issued by the FAA and require the airline to perform modifications or additional inspections and checks or install additional equipment on existing aircraft. See **airworthiness**

Allowance for obsolescence. An allowance for obsolescence is established by airlines to distribute the cost of expendable spare parts expected to be on hand at the end of a fleet's life over the service lives of the related equipment. Typically, the spare parts obsolescence provision for the period is calculated by taking the historical cost of the spare parts; reducing it by the estimated base stock, the estimated salvage value, and the current allowance for obsolescence; and then dividing the remaining amount by the remaining useful or average service life of the aircraft to

which the parts relate.

Amendable labor contracts. Collective bargaining agreements that under the provisions of the Railway Labor Act of 1926 (RLA), which governs the labor relations of employers and employees engaged in the airline industry, do not expire but rather become amendable as of a stated date. Comprehensive provisions are set forth in the RLA establishing the right of airline employees to organize and bargain collectively along craft or class lines and imposing a duty upon air carriers and their employees to exert every reasonable effort to make and maintain collective bargaining agreements. The RLA contains detailed procedures that must be exhausted before a lawful work stoppage may occur. Under the RLA, an amendable labor contract continues in effect while the parties negotiate a new contract.

Auditor's coupon. The initial document used to record the sale of a paper ticket. See **paper ticket.**

Available seat miles (ASMs). The aircraft miles flown on each flight segment multiplied by the number of seats available for revenue use on that segment.

Available seats. Installed seats in an aircraft (including seats in lounges), exclusive of any seats not offered for sale to the public by the carrier, provided that in no instance shall any seat sold be excluded from the count of available seats.

Available ton miles (ATMs). The aircraft miles flown on each flight segment multiplied by the number of tons available for the transportation of passengers, freight, mail, and express for revenue use on that segment.

Average aircraft utilization. Ratio of time the aircraft is used divided by the time the aircraft is available. It is expressed in hours per day.

Average flight segment length. The average distance in statute miles covered by an aircraft in revenue service from takeoff to landing.

Beyond flying capability (also referred to as *beyond right*). The right to fly beyond the territory of the party to a bilateral aviation agreement to a third country, either with or without the right to take on passengers and cargo in the partner's country.

Block-to-block aircraft hours. The hours from the moment an aircraft first moves under its own power (including taxi time before takeoff and after landing) for purposes of flight until it comes to rest at the next point of landing. This term is sometimes referred to as *ramp-to-ramp aircraft hours.*

Break-even load factor. The load factor in scheduled revenue service that is required for scheduled passenger revenue less passenger traffic expense to equal passenger capacity expense. The split into types of cost is not strictly *fixed* versus *variable* costs as those terms are used in accounting literature. See **traffic expense** and

capacity expense.

Built-in overhaul. The portion of the cost of flight equipment that represents the estimated cost of the initial overhaul of the flight equipment.

Buyer-furnished equipment (BFE). Interior parts of the aircraft provided by the airlines purchasing the aircraft to the aircraft manufacturer for use in the assembly process. BFE typically includes seats, galleys, overhead bins, in-flight entertainment systems, and other equipment that the airline uses to provide customer service.

Capacity purchase agreement. Contracts under which the major carrier "purchases" the use of the regional airline's aircraft and flight crews and other related services. The aircraft is painted in the colors and logos of the major airline, and the major airline also takes responsibility for aircraft scheduling, ticket pricing, reservations, collections, and marketing. Ground handling of the aircraft may be performed by either the major carrier or the regional airline. See **fee-per-departure contract** and **cost-based contract**.

Capacity expense. Expense related to the provision of available aircraft capacity, regardless of the degree to which that capacity is utilized.

Cargo ton mile (CTM). One ton of cargo (freight, express, and mail) transported one mile.

Code-sharing. A practice where a flight operated by an airline is jointly marketed as a flight for one or more other airlines. Under a code-sharing agreement, participating airlines can present a common flight number or use different flight numbers. The airline that actually operates the flight is called the operating carrier. The airline or airlines that sell tickets for that flight but do not actually operate it are called marketing carriers. Such alliances also usually tie in each airline's marketing and frequent flyer programs and provide for schedule coordination for convenient connections between airlines.

Cost-based contract. A form of the capacity purchase agreement between a major airline and a regional airline under which the regional carrier is compensated based on specific costs it incurs plus a margin. Typically, under cost-based contracts, the regional carrier's revenue consists of three elements: (1) reimbursement of costs over which the regional carrier has control, which is based on a fixed rate applied to some measure of operations (for example, flight hours, passengers carried, cycles, or block hours); (2) reimbursement of costs over which the regional carrier typically has no control, which is done on an actual or pass-through cost basis; and (3) a profit or margin component. See **capacity purchase agreement** and **fee-per-departure contract**.

Coupon. Coupon is a component of a paper ticket (see **paper ticket**, **flight coupon**,

lifted flight coupon, and **auditor's coupon**). The term *coupon* is also used to refer to the value associated with each individual flight segment, which can be evidenced by lifted flight coupons and other electronic evidence of boarding the individual flight segment, in which case it is applicable to both paper and electronic tickets. See **electronic ticket**, **online ticket/coupon**, and **off-line ticket/coupon**.

Deplaned traffic. A count of the number of passengers exiting and tons of cargo being unloaded from an aircraft. For this purpose, passengers and cargo on aircraft leaving a carrier's system on interchange flights are considered to be deplaning at the interchange point; passengers and cargo moving from one operation to another operation of the same carrier, for which separate reports are required by the Department of Transportation (DOT), are considered to be deplaning at the junction point.

Depressant. Depressant is used to simplify the calculations involved in interline billing process. The depressant is based on a historical ratio of standard local fares to settled fares and is used to adjust the current month's interline billings.

Developmental costs. Developmental costs include those types of costs directly related to the development of new routes (or extension of existing routes), such as advertising and promotion expenses, related travel and incidental expenses, and expenses of regulatory proceedings.

Electronic ticket (e-ticket). An e-ticket reflects the passenger's itinerary in electronic form. Like paper tickets, e-tickets contain information for each flight segment of a passenger's itinerary. However, while a paper ticket consists of multiple coupons that are used to record a sale and to document the service rendered, e-tickets exist only as a digital record in the airline computer system and contain no paper coupons. (Please note that in practice and in this guide, the term *coupon* is often used to collectively refer to lifted flight coupons and other electronic evidence of boarding, in which case it is applicable to both paper and electronic tickets.) Instead, the airline's host reservation system or global distribution system (GDS) produces an e-ticket sales record for each sale transaction, which is used to record a sale of e-ticket. Boarding documents are issued for e-tickets at check-in, and the carrier documents transportation service at the boarding point by either collecting boarding documents or scanning them as evidence of the service rendered. See **coupon**, **lifted flight coupon**, and **paper ticket**.

Enhanced equipment trust certificate (EETC). Leasing structure used by airlines to finance aircraft acquisitions. These structures are initially the same as equipment trust certificates, except that additional series of trusts are involved to modify the cash flows in order to provide for a number of credit ratings to improve the overall creditworthiness of the debt securities issued by the equipment trust. Depending on how the third-party investment is structured, EETCs generally result in either debt or an operating lease from the airline's perspective. See

equipment trust certificate.

Enplaned traffic. A count of the number of passengers boarding and tons of cargo being loaded on an aircraft. For this purpose, passengers and cargo on aircraft entering a carrier's system on interchange flights are considered to be enplaning at the interchange point; passengers and cargo moving from one operation to another operation of the same carrier, for which separate reports are required by the DOT, are considered to be enplaning at the junction point.

Equipment trust certificate (ETC). Leasing structure used by airlines to finance aircraft acquisitions. Typically in these transactions, the aircraft is placed in a trust with an equity participant (other than the airline) and then the trust issues debt to public or private parties to fund the remainder of the acquisition of the aircraft, which is then leased back to the airline (alternatively, the agreement between the trust and the airline can be structured as debt). See **enhanced equipment trust certificate**.

Expendable parts. Parts that cannot be economically repaired, reconditioned, or reused after removal from the aircraft. See **repairable parts** and **rotable parts**.

Fare. The amount per passenger or group of persons stated in the applicable tariff for the transportation, including baggage (unless otherwise specified).

Fee-per-departure contract. A form of the capacity purchase agreement between a major airline and a regional airline under which the regional carrier is compensated based on a rate per departure. The rate is intended to cover all of the costs and a profit margin for operation of the specified flight. This rate is generally either a per-departure amount (for a specified origin and destination) or an amount per block hour of operation. See **capacity purchase agreement** and **cost-based contract**.

Fifth freedom right. The right to enplane traffic at one foreign point and deplane it in another foreign point as part of the continuous operation also serving the airline’s homeland.

Flag stop. A point on an air carrier's predetermined route that is scheduled to be served only when traffic is to be picked up or discharged.

Flight coupon. A coupon in a paper ticket issued for transportation that contains the itinerary of the passenger(s) but is valid only for carriage between the passenger's point of enplanement and deplanement on a single flight, as noted on the coupon. It also includes the class of service, stopover code, carrier, date of travel, flight number, and applicable fee. See **coupon**, **lifted flight coupon**, **paper ticket**, and **electronic ticket**.

Flight equipment. Airframe, aircraft engines, aircraft propellers, aircraft

communications and navigational equipment, miscellaneous equipment used in the operation of the aircraft, and improvements to leased flight equipment.

Flight leg. See **flight segment**.

Flight segment. A flight segment is defined as a takeoff and a landing. It is a segment of a flight involving a stopover, change of aircraft, or change of airline. It is also referred to as *flight leg*.

Frequent flyer programs (FFPs). Programs used by airlines to encourage passenger loyalty by providing rewards geared to the frequency of travel on the sponsoring airline, typically in the form of frequent flyer miles, points, or segments that can be accumulated and converted into free or discounted travel.

Gate. A section at an airport terminal for transferring passengers and airline crews to an aircraft. This intangible asset represents the right to use a gate. A gate is generally recorded as a separate asset if the right to use the gate is acquired from another airline.

Interline airlines. Airlines that have agreed to provide transportation interchangeably with other carriers. See **noninterline airlines** and **interline ticketing.**

Interline ticketing (also known as *interlining*). A commercial agreement between individual airlines to handle passengers traveling on itineraries that require multiple airlines. Interlining agreements are voluntary. Low-cost carrier airlines that only sell directly to consumers (and not through agencies or GDS systems) typically do not support interlining at all. If no interline ticketing agreement exists, separate tickets will need to be issued and passengers will have to retrieve their checked-in luggage and carry it to the connecting airline for check-in. Interlining agreements differ from code-sharing agreements in that code-sharing agreements usually refer to numbering a flight with the airline's code even though the flight is operated by another airline. However, code-share relationships can affect whether an interline ticket can be issued. Both the code-share marketing carrier and code-share operating carrier must have interline agreements with all other carriers in the itinerary to allow a single ticket to be issued. See **code-sharing**.

International route authority. A right to operate flights to foreign markets. Route certificates are awarded by the U.S. government to individual U.S. registered carriers on a temporary basis and can be renewed upon expiration by the DOT.

Invalid ticket. A ticket that has lost its value. It generally occurs at departure date or, in certain circumstances, at some point subsequent to departure date but prior to its contractual expiration date. See **valid ticket.**

Joint fare. A fare, published as a single factor, that applies to transportation over the

joint lines or routes of two or more carriers and is made and published by arrangements or agreement among the carriers, evidenced by concurrence or power of attorney. See **local fare.**

Landing fees. Fees paid to an airport or other governmental authority for each aircraft landing. Usually, the fees are levied on the weight of the aircraft that has landed.

Lifted flight coupon. The coupon that is detached from the paper ticket booklet by the carrier providing the transportation service at the boarding point as evidence of the service rendered. See **coupon**, **flight coupon**, **paper ticket**, and **electronic ticket**.

Load factor. The percentage of revenue passenger miles to available seat miles in revenue passenger service, representing the proportion of aircraft seating capacity that is actually utilized. For cargo, the term refers to the percentage of cargo revenue ton miles to available cargo ton miles.

Local fare. A fare that applies to transportation over the lines or routes of one carrier only. See **joint fare.**

Marketing carrier. The airline or airlines that participate in code-sharing agreements and sell tickets for the flight but do not actually operate it. See **operating carrier**.

Noninterline airlines. Airlines that only issue tickets that may be used for transportation on the airline's own flights and provide transportation only to passengers holding tickets issued by the airline. See **interline airlines** and **interline ticketing.**

Nonrevenue traffic. Passengers and cargo transported by air for which no remuneration or token service charges are received by the air carrier. Airline employees, passengers redeeming their FFP awards, officers, directors, or other persons, except for ministers of religion, who are traveling under reduced-rate transportation authorized by section 403(b) of the Federal Aviation Act and part 223 of the board's economic regulations. Travel agents, cargo agents, and tour conductors traveling at reduced fares are also considered nonrevenue traffic. See **revenue traffic**.

Off-line (OAL) carrier. Carrier on which transportation is scheduled but which did not sell the ticket. See **online (OL) carrier**.

Off-line or other airline (OAL) sale. A ticket sold by one airline that includes flight segments to be traveled on another airline. See **online (OL) sale**.

Off-line (OAL) ticket/coupon. Tickets sold by other airlines and used by passengers on the operating carrier. See **online (OL) ticket/coupon**.

Online (OL) carrier. Carrier that issues the ticket and collects the total fare from the

passenger. The OL carrier then settles the fare with the other carriers on which transportation is scheduled, known as OAL carriers, on the basis of interline agreements. See **off-line (OAL) carrier**.

Online (OL) sale. A ticket sold by an airline in which transportation on all flight segments will be provided only by that airline. See **off-line (OAL) sale**.

Online (OL) ticket/coupon. Tickets sold by the carrier providing transportation and used by the passenger on that airline. See **off-line (OAL) ticket/coupon**.

Operating carrier. The airline that actually operates the flight. It provides the plane, the crew, and the ground handling services. See **marketing carrier**.

Oversale (overbooking). The sale of (or, in the case of overbooking, the acceptance of reservations for) more space (passenger seats) than is actually available on a flight. A practice that is used sometimes by the air carriers as an allowance for that historical percentage of passengers who fail, for some reason, to use the space they have reserved on a flight. In those cases in which the actual number of passengers with purchased tickets exceeds the available space for a flight, the carrier is liable for denied boarding compensation to those passengers not accommodated on the flight or on comparable air transportation.

Paper ticket. A printed document that serves as evidence of payment of the fare for air transportation. It authorizes carriage between the points and via the routing indicated and also shows the passenger's name, class of service, carrier(s), flight number(s), dates of travel, and all conditions of the contract of carriage. Generally, this takes the form of the standard Air Traffic Conference ticket, which is composed of an auditor's coupon, agent's coupon, flight coupon(s), and passenger's coupon. The auditor's coupon is the initial document used to record a sale. Flight coupons represent each flight segment (leg) of the passenger's itinerary. Flight coupons are lifted (detached from the ticket booklet) by the carrier providing the transportation service at the boarding point as evidence of the service rendered, although today this process is entirely electronic for the vast majority of ticket sales and boarding transactions. See **coupon**, **flight coupon**, **lifted flight coupon**, **auditor's coupon**, and **electronic ticket**.

Passenger facility charges (PFC). The PFC Program allows the collection of PFC fees for every enplaned passenger at commercial airports controlled by public agencies. Airports use these fees to fund FAA-approved projects that enhance safety, security, or capacity; reduce noise; or increase air carrier competition.

Passenger mile. One passenger transported one mile. Passenger miles are computed by multiplying the aircraft miles flown on each flight stage by the number of passengers transported on that stage.

Power-by-the-hour (PBTH) contract. An arrangement for outsourcing scheduled

maintenance activities. These contracts generally provide that, in exchange for a payment of a fixed amount per flight hour or other applicable unit of measurement associated with the aircraft (for example, block hours or cycles), the maintenance provider will provide specified maintenance activities associated with a particular aircraft for a specified period. See **time-and-material contract**.

Preoperating costs. Preoperating costs include costs related directly to adding a new aircraft type to an airline's fleet, such as flight crew training, maintenance training, prerevenue flight expenses, insurance, and depreciation.

Prorate agreement. See **proration**.

Proration. Method of dividing the total fare among the concerned carriers according to the joint fares published in the Industry Prorate Manual or in accordance with existing agreements between the airline partners, which are frequently referred to as *special prorate agreements*. Interline, code-sharing, and alliance agreements, as well as some contracts between major and regional airlines, typically use proration to allocate revenue among the airlines.

Ramp-to-ramp aircraft hours. See **block-to-block aircraft hours**.

Rate. The amount per unit stated in the applicable tariff for the transportation of property.

Repairable parts. Parts that are repairable and reusable but with economic useful lives generally less than the aircraft they support and values less than most rotable parts. See **expendable parts** and **rotable parts**.

Retroactive wages. A provision that may be included in a newly negotiated collective bargaining agreement that calls for payments to airline employees to compensate them for services provided during the period between the amendable date of the old collective bargaining agreement and the ratification date of the new contract (the amendable period).

Revenue breakage. The recognition of revenue before the airline has performed all its obligations under the sales arrangement because the customer has not required the airline to perform and is unlikely to do so. Revenue breakage consists of refundable and nonrefundable tickets that remain unused past departure date, have continuing validity (valid tickets), and are expected to ultimately expire unused and valid travel vouchers that are not expected to be redeemed prior to their expiration date. See **air traffic liability (ATL) breakage**, **valid ticket**, **invalid ticket**, and **travel voucher**.

Revenue passenger. One fare-paying passenger transported by the carrier.

Revenue passenger mile (RPM). One fare-paying passenger transported one mile. Revenue passenger miles are computed by multiplying the number of revenue passengers by the miles that they are flown.

Revenue ton mile. One ton of revenue traffic transported one statute mile. Revenue ton miles are computed by multiplying tons of revenue traffic (passengers, freight, mail, and express) by the miles that this traffic is flown.

Revenue traffic. Passengers and cargo transported by air for which remuneration is received by the air carrier. Airline employees, passengers redeeming their FFP awards, officers, and directors or other persons, except ministers of religion, who are traveling under reduced-rate transportation authorized by section 403(b) of the Federal Aviation Act and part 223 of the board's economic regulations. Travel agents, cargo agents, tour conductors traveling at reduced fares, and other passengers and cargo carried for token service charges are not considered revenue traffic. See **nonrevenue traffic**.

Rotable parts. Parts that are significant in value and can be repaired and reused such that they typically have an expected useful life approximately equal to the aircraft they support. See **expendable parts** and **repairable parts**.

Scheduled departure. A takeoff scheduled at an airport, as set forth in published schedules.

Slot. Right allocated to an airline by an airport or government agency granting an airline the right to conduct a landing or takeoff at a specific time.

Snowball billing. The billing process used in collect air cargo shipments whereby each air cargo carrier that participates in a collect shipment bills the adjacent downline air cargo carrier in the route segment for all transportation services up to the point of transfer to that air cargo carrier, thus "snowballing" the bills to the collecting air cargo carrier. This is done because upline air cargo carriers, due to shipment reroutings, frequently do not know the identity of the collecting air cargo carrier.

Tariff. The notice of fares and rates applicable to the transportation of persons or property and the rules relating to or affecting such fares and rates of transportation.

Time-and-material contract. An arrangement for outsourcing scheduled maintenance activities. Traditional time-and-material contracts may fix certain components of the cost, but much of the contract price is based on actual cost at the time the maintenance event takes place. See **power-by-the-hour (PBTH) contract**.

Traffic expense. Expense that relates to, and varies with, the traffic (passenger or cargo or both) actually transported. It includes such cost elements as traffic servicing expenses, reservations and sales expense, and advertising and publicity expense.

Traffic servicing expense. Compensation of ground personnel and other expenses incurred on the ground incident to handling traffic of all types and classes on the ground subsequent to the issuance of documents establishing the air carrier's responsibility to provide air transportation. It includes expenses attributable to the operation of air traffic offices but not costs of reservation sales centers. It also includes expenses of enplaning and deplaning traffic.

Travel agent commission. The payment by airlines to a travel agent of specified amounts of money in return for the agent's sales of air transportation.

Travel voucher. Certificate for free or discounted travel that is generally issued in connection with denied boarding situations or as an enticement to accept a voluntary change in flights. Travel vouchers may also be issued to passengers as compensation related to other customer service issues. Travel vouchers are usually issued for either free travel or for a fixed amount that can be used by the passenger to pay for future travel purchases from the issuing airline.

Unearned transportation revenue. See **air traffic liability**.

Unmatched usage. It occurs when a passenger uses a ticket and the airline has no record of the original ticket sale.

Valid ticket. A ticket that maintains its validity (that is, the ticket has value and the customer can travel with the ticket, exchange it for future travel, or obtain a refund) until its contractual expiration date. See **invalid ticket**.

Wet lease. An aircraft lease in which the lessor provides the aircraft, the crew, fuel, maintenance, and other services necessary to operate the flight.

Yield. The average revenue per unit of traffic carried in revenue service. Usually, yield is calculated as average revenue per revenue passenger mile, or cents per RPM. For cargo, it is calculated as average revenue per cargo revenue per ton mile, or cents per CTM.

Proposed AICPA Audit and Accounting Guide

Airlines

Appendix A

Status of Incremental GAAP

This appendix provides an analysis of those sections of the May 1, 2003, edition of the AICPA *Audits of Airlines* Industry Audit Guide that have been tentatively identified by Financial Accounting Standards Board (FASB) staff to contain accounting principles that are not promulgated elsewhere (referred to as *incremental GAAP*). As explained in the Notice to Readers of the proposed guide, the May 1, 2003, edition of this guide has established incremental GAAP. The 2003 edition is not superseded because it remains a source of level *b* GAAP and the proposed guide brings forward incremental GAAP from the 2003 edition.

For each paragraph, this appendix presents an excerpt from the 2003 edition of the guide and references to where this guidance appears in the proposed revised guide along with any explanations, as necessary.

2003 Edition of the Guide:

2.04 The inventories in an airline operation are for internal consumption and not for sale; they therefore differ substantially from the classical definition. Inventories in an airline operation comprise primarily *expendable (spare) parts* and *materials and supplies* used in the airline's operation. Such inventories are valued at cost, less an allowance for obsolescence that corresponds to the lives of the related fleets.

Note: The term *inventory* is not being used in the revised guide. The concepts contained in this paragraph have been preserved in Chapter 4 of the revised guide, in the "Spare Parts" section (paragraph 4.90) and in the "Allowance for Obsolescence" section (paragraph 4.95).

2003 Edition of the Guide:

3.02 Since airline tickets usually are issued in advance of the scheduled transportation date, the ticket sales date seldom coincides with the revenue recognition date, also referred to as the service date. Therefore, the task for airline revenue accounting is twofold:

1. To record unearned revenue when a ticket is sold and scheduled service is at a later date.
2. To recognize revenue when the carrier provides the transportation service and thereby completes the earnings process.

Note: This paragraph is retained in the revised guide with minor editorial revisions in Chapter 3 of the revised guide, in the "Introduction" section (paragraph 3.03).

2003 Edition of the Guide:

3.07 An airline ticket consists of several coupons indicating the itinerary of the passenger. One copy is the auditor's coupon, which is the initial document used to record a sale. An additional coupon represents each segment (leg) of the passenger's itinerary. This coupon is lifted (detached from the ticket booklet) by the carrier providing the transportation service at the boarding point as evidence of the service rendered.

Note: This paragraph is retained in the revised guide with minor editorial revisions Chapter 3 of the revised guide, in the "Ticket Types" section of the "Ticketing" part of the chapter (paragraph 3.11).

2003 Edition of the Guide:

3.08 A ticket sold by an airline and ultimately used on that airline is referred to as an on-line (OL) sale; a ticket sold by one airline and used on another airline is

referred to as an off-line (OAL) sale. One ticket can include several flight segments and, also, can include flights on various carriers. The carrier that issues the ticket collects the total fare from the passenger. Settlements of this fare are made among the other carriers on the basis of interline agreements (described in a later section of this chapter). In this case, the selling carrier is known as the OL carrier, and all other carriers for which transportation is scheduled are the OAL carriers.

Note: This paragraph is retained in the revised guide with minor editorial revisions Chapter 3 of the revised guide, in the "Interline Ticketing" section of the "Ticketing" part of the chapter (paragraph 3.14).

2003 Edition of the Guide:

3.37 Lifted flight coupons represent earned revenue, whether they originate as on-line or as off-line sales. On-line lifts indicate that one carrier has completed the sales cycle, both selling the ticket and providing the service. The carrier must process on-line lifts in order to determine the amount to be transferred from the unearned to the earned revenue account. Each OL coupon can be entered in a sales/lift match file if that is the method of revenue recognition used by the carrier. Such files range from a ticket number file to a detailed data history file for each coupon. Revenue may be determined by valuing each coupon lifted or by sampling the lifted coupons.

Note: This paragraph has not been retained verbatim in the revised guide, but its concepts have been preserved in Chapter 3 of the revised guide, in the "Passenger Travel" section (paragraph 3.36) and in the "Introduction" section (paragraph 3.04). Also, the terminology used in this paragraph was modified in the revised guide to address e-tickets.

2003 Edition of the Guide:

3.40 There are two basic methods for calculating earned revenue: the sales/lift match method and the sampling method.

3.41 *Sales/Lift Match Method*. The principal objectives of the sales/lift match method are to record all sales information by coupon and to match the usage of all recorded coupons. In this type of system, all OL coupons issued must be recorded in the air traffic liability account and tracked by ticket and coupon number. Lifted OL flight coupons are matched against the recorded coupons, and this usage amount is deducted from air traffic liability and added to earned revenue. Interline payable billings by other carriers also represent a usage of OL sales, which must be matched against the recorded coupons and deducted from the air traffic liability account. Adjustments to the unearned revenue account are made periodically for unmatched tickets, lost tickets, or tickets not processed for some other reason.

3.42 In such a system, OAL lifts are directly recorded as revenue…

3.43 *Sampling Method*. The objective of the sampling method is to recognize revenue on the basis of a survey of lifted off-line and on-line coupons for the period. There are two attributes for which a sample of lifted coupons may be tested: number of revenue passenger miles or number of revenue passengers. When the revenue-passenger-mile attribute is used, a sample of the dollar value of coupons is accumulated and divided by RPMs flown to produce an average yield per RPM. This average yield is then multiplied by the total number of revenue passenger miles flown by the carrier to determine earned revenue. The number-of-passengers attribute system develops an average fare per passenger from the sample. Earned revenue is then determined by applying this average fare to the number of passengers transported for the period. The average yield per RPM is the most common attribute used for sampling systems.

3.44 Carriers use various methods to sample lifted coupons, such as testing all lifted coupons with a number ending in a selected digit. If statistical sampling methods are used by the airline, the independent auditor must be satisfied that the sampling plan has statistical validity, that it has been properly applied, and that the resulting precision and reliability, as defined statistically, are reasonable in the circumstances.

3.45 Under the sampling method, all off-line lifts are initially recorded in the air traffic liability account (in which on-line tickets were previously recorded). All lifts are processed for statistical data required by the DOT and for the required sampling data. Earned revenue is recognized on the basis of the sampling data of all lifts and is deducted from the total of coupons recorded in the air traffic liability account. Off-line coupons are recorded in the air traffic liability account to develop a total of all coupons sold, from which revenue of lifted coupons can then be recognized. Interline payable billings are deducted from the air traffic liability account when they are paid. Differences, such as those arising from clerical inaccuracies, between amounts originally recorded and amounts billed may be rejected and rebilled, or written off if the original recorded fare was incorrect.

Note: These paragraphs have not been retained verbatim in the revised guide, but their concepts have been preserved in Chapter 3 of the revised guide, in the "Revenue Recognition Methods" section (paragraphs 3.51–.55). Also, the terminology used in these paragraphs was modified in the revised guide to address e-tickets and the method that was previously referred to as *sales/lift match* has been renamed as *sales/use match*.

2003 Edition of the Guide:

3.53 Revenue accounting for air cargo concerns the determination of what charges should be paid by whom for the air freight services performed. The revenue recognition process is similar to that for passenger transportation: to record unearned revenue when an airbill is sold and to recognize revenue when a carrier provides the shipping service and thereby completes the earning process.

Note: This paragraph has not been retained verbatim in the revised guide, but its concepts have been preserved in Chapter 8 of the revised guide, in the "Revenue Recognition and Measurement" section (paragraph 8.08).

2003 Edition of the Guide:

3.64 For accounting purposes, airframe and aircraft engine overhauls encompass all inspections or replacements of major components, which the civil air regulations require at specific maximum periodic intervals to recertify that the frame or engine is completely airworthy. An overhaul does not include, however, the cost of routine replacement of minor parts and servicing or inspection of airframes and aircraft engines. Also excluded from overhauls are costs accounted for as restoration of assets, such as extraordinary costs associated with the renewal of major structural parts beyond the scope of normal periodic overhauls, and other costs with a life span similar to the depreciable service life of the related airframe or aircraft engine.

Note: This paragraph is retained in the revised guide with minor editorial revisions in Chapter 4 of the revised guide, in the "Aircraft Maintenance" section (paragraph 4.73).

2003 Edition of the Guide:

3.69 Air carriers should adopt an accounting method that recognizes overhaul expenses in the appropriate period. This may result in different methods for different aircraft, as well as different methods for airframe overhauls and engine overhauls. The method chosen should recognize, among other things, the carrier's operating practices with respect to airframe and engine overhauls.

3.70 *Direct Expensing Method* - All trunk carriers and some others recognize the cost of overhauls as expenses as they are incurred because, in the case of carriers with large fleets, such costs are relatively constant from period to period.

3.71 *Built-in Overhaul Method* - The built-in overhaul method is based on segregation of the aircraft costs into those that should be depreciated over the useful life of the aircraft and those that require overhaul at periodic intervals. Thus, the estimated cost of the overhaul component included in the purchase price is set up separately from the cost of the airframe and engines and is amortized to the date of the initial overhaul. The cost of the initial overhaul is then capitalized and amortized to the next overhaul, at which time the process is repeated.

3.72 *Deferral Method* - Under the deferral method, the actual cost of each overhaul is capitalized and amortized to the next overhaul.

Note: The presentation of the paragraphs in the previous list is consistent with FASB Staff Position AUG AIR-1, *Accounting for Planned Major Maintenance Activities.* These paragraphs have not been retained verbatim in the revised guide, but their concepts have been preserved in Chapter 4 of the revised guide, in the "Expense Recognition" section (paragraphs 4.75–.78).

2003 Edition of the Guide:

3.87 In addition to the normal month-end salary accrual, other accruals frequently are associated with the payroll costs of flight personnel:

- ….
- *Retroactive pay accrual.* When employees continue to work after the expiration date of their contract, the airline generally accrues an amount representing the anticipated increase in wage rates and certain fringe benefits because such increases are generally retroactive to the expiration date of the prior contract. Consideration should be given to the provisions of FASB Statement No. 5, *Accounting for Contingencies.* Determinations should be made of the probability that the increase will be retroactive and of whether the amount is reasonably estimable at the audit date.

Note: This section has not been retained verbatim in the revised guide, but its concept has been preserved in Chapter 5 of the revised guide, in the "Accounting Guidance" section of the "Amendable Labor Contracts" part of the chapter (paragraphs 5.06–.08).

2003 Edition of the Guide:

3.96 Airlines frequently negotiate purchase incentives with aircraft manufacturers whereby, as an inducement to purchase a particular manufacturer's aircraft, the manufacturer will issue credits, which can be used for the purchase of spare parts but may not be applied as part of the purchase price of aircraft. Examples of other incentives are guaranteed trade-in values and purchase credits for flight crew training equipment (flight simulators). For accounting purposes, though, the credit can be applied as a reduction of the purchase price of the aircraft or amortized over the life of the related aircraft.

Note: This paragraph was not retained verbatim in the revised guide, but its concepts were preserved in Chapter 4 of the revised guide, in the "Manufacturer Purchase Incentives" section (paragraphs 4.14–.15 and 4.17).

2003 Edition of the Guide:

3.103 A depreciation method may be applied to a single asset (unit depreciation) or to a group or pool of assets that are similar in nature (group depreciation). Under the unit method, the airline depreciates the cost of the individual items of property and equipment. Under the group method, the airline depreciates the aggregate cost of a group of equipment that is fairly homogeneous, despite differences in the service lives of individual items.

3.104 An air carrier can use unit or group depreciation methods on different groups of assets. Group depreciation usually is applied to groups of assets that are significant in number but have relatively small unit values, such as rotable parts

and assemblies. In these cases, the ease of application is the basis of selection between the two methods. Unit depreciation is generally used for other fixed assets, such as aircraft and engines, that have large unit costs and are comparatively few in number.

Note: In the revised guide, the terms *unit depreciation* and *group depreciation* were replaced with the phrases *depreciation on an individual basis* and *depreciation on a pooled basis* to avoid confusing the group depreciation method as used in the original guide with the group-life and mass-asset depreciation methods that are applied to large groups of homogeneous assets and primarily used in the utility, telecommunications, and railroad industries. The paragraphs previously listed were not retained verbatim in the revised guide, but their concepts were preserved in Chapter 4 of the revised guide, in the "Depreciation" section (paragraph 4.63) and in the "Depreciation of Rotable and Certain Other Spare Parts" section (paragraph 4.64).

2003 Edition of the Guide:

3.117 Rotable parts and assemblies of significant value are classified along with flight equipment as fixed assets, and expendable parts are classified as current assets.

3.118 Both rotable and expendable parts relate to flight equipment. Their classification ordinarily depends on the carrier's maintenance program.

3.119 Some carriers base the distinction between rotable and expendable parts on manufacturer or engineering studies, while other carriers have a unit value limitation below which a rotable part becomes an expendable part.

3.120 Because they are fixed assets, the asset valuation of rotable parts and assemblies is similar to that of all other property and equipment. Rotable parts and assemblies are normally depreciated over their useful lives or service lives according to a group method of depreciation. Generally, the cost of repairing rotables is charged to expense as it is incurred.

3.121 Expendable parts are recorded at cost in a current asset account for spare parts and supplies, which is similar in nature to a prepaid expense, and are charged to expense as they are used. Materials and supplies held in small quantities and purchased as needed are charged to expense when they are purchased.

Note: These paragraphs have not been retained verbatim in the revised guide, but their concepts have been preserved in Chapter 4 of the revised guide, in the "Spare Parts" section (paragraphs 4.90–.91). Also, the revised guide does not retain reference to assemblies because assemblies are a type of rotable parts.

2003 Edition of the Guide:

3.122 Reusable spare parts and supplies recovered in connection with construction, maintenance, or retirement of property and equipment are included with expendable parts at the average cost of comparable items. This valuation is typically based on the condition of the part or group of parts and their continuing utility.

Note: This paragraph is retained in the revised guide with minor editorial revisions in Chapter 4 of the revised guide, in the “Spare Parts” section (paragraph 4.94).